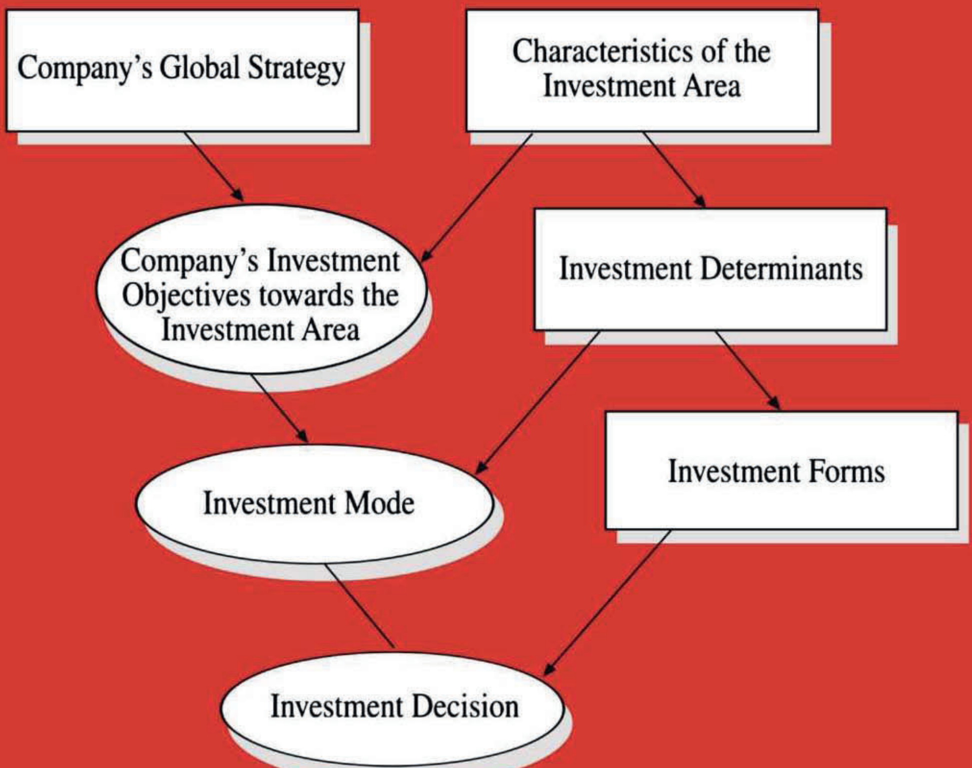
Cross-Border Investing

The Case of Central and Eastern Europe

Julia Djarova



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Dr Julia Djarova
ECORYS-NEI and Erasmus University
Rotterdam, The Netherlands

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In memory of Jan Willem

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Preface

It was in the winter of 1992. I was sitting in the waiting hall of the Airport of Prague, the capital of Czechoslovakia at that time. My attention was drawn by a group of people who seemed to be waiting for arriving passengers. The group was speaking German. I noticed that they were prepared to wave a flag at the moment their passengers would come out of the gates. The flag had the logo of Skoda with an addition of "Volkswagen", all in German. Another group, a group of children dressed up in Czech national costumes, soon joined the group. Men with instruments and a lady leader accompanied them. Suddenly they all became noisy and impatient. The expected passengers, a group arriving from Munich, were coming out. Waving flags, noisy German talk and children dancing Czech national dances. I thought, it all reminds me of the time when high communist officials were met at the airports of Central and Eastern Europe. It also made me thinking about the Volkswagen-Skoda deal and recent East-West business undertakings in general. What do all these deals mean to Western and Eastern companies? Are they the beginning of a new history of the multinationals in a part of the world that was hiding behind an iron curtain and now is called emerging? Is there a new pattern in multinationals expanding into the so-called countries in transition or is this simply international business as usual?

It is more than 10 years since that winter and in this period there is a lot happened: years of unprecedented developments in Central and Eastern Europe. Multinationals have been major players in these developments. They have responded to the call of opportunities and they have experienced the

problems being first, all this with a strategy in mind: sometimes successful, sometimes not.

This book looks at the years of extensive foreign investment into Central and Eastern Europe: a new period of East-West business relationships. It discusses what has driven the multinationals to choose a particular investment decision from the palette of possible options. It shows how much the region means to the multinationals and how much do the multinationals mean to the region.

Is the euphoria I have observed in the winter of 1992 all gone?

Julia Djarova

Acknowledgements

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I highly value the readiness of a number of top managers and companies' experts to support me in writing the case studies. It was my pleasure to have useful contacts and interesting discussions with Mr T. J. M. van Hedel and Mr J. Cheriex (Numico), Mr E. H. M. Driebeek, Mr J. C. A. Martin, Mr J. McCarthy and Mr D. J. Ledeboer (Unilever), Mr C. D. van der Vijver (Sara Lee/DE), Mr Th. J. Bark and Mr K. Sheikh (ABN AMRO), Mr M. Gosens (ING Group).

I would like to thank my editors at Kluwer Academic Publishers who have been extremely understanding and supportive in the process of putting the book's material together.

I thank my husband, Hans, for his appreciation and enthusiasm for my work, my son Gooitzen and my nephew Martijn for helping me with the electronic layout and my son Javor for his support during the final editing of the book.

Julia Djarova

Foreword

The world is confronted with considerable differences in wealth between countries. The reasons for this disparity are manifold. They have to do with (historical) differences in endowments with productive factors, but also with differences in the quality of the infrastructure, institutions, etc. In Europe this disparity is particularly acute between the Western countries on one hand and the Central and Eastern European countries (CEECs) on the other.

The catching up of the less well to do countries with the richer countries is dependent on their capacity to improve the productivity of their labour and capital, which implies the moving into new and high value added activities. Foreign direct investment plays in this respect a key role. It brings to the host country not only the necessary capital, but also modern ways of management, access to technological innovation and market power. Together these elements are a prerequisite for fast growth of productivity and hence catching up.

Governments of host countries will make sure that they provide good conditions for foreign investors so as to enhance the growth of their economy. To that end they carry out policies (involving considerable sums of money) to realise improvements in the location profile of their country that may be of interest to foreign investors. In the case of Central and Eastern European countries the EU supports these public efforts under several programmes.

Modern business is highly specialised and internationalised. It means that much of today's production is actually generated by multinational firms. They are constantly at the look out for the best locations for part of their production processes, often splitting functions between locations. Highly urbanized areas with a diversified supply of services and with a sophisticated

supply of human resources will then attract the R&D and management functions while the more routine manufacturing functions will tend to locate in regions with a large and relatively cheap supply of qualified labour and good communications to the market.

Firms are constantly revising their productive systems in the light of the new condition in matters of markets, technology regulation and so on. In the past many firms from Western Europe have seized the new opportunities that the opening up of Central and Eastern Europe to the world market offered them. Some have relocated activities from production sites in the West to new sites in the East. Others have added new capacity to cater for the expanding markets in the CEECs. Together these actions have made it possible for such firms to stay abreast in the competitive game.

Given the crucial importance of FDI, it need not surprise that it has attracted a lot of attention, not only from policy and business circles but also from the academic community. As a matter of fact we have seen in recent years a real avalanche of books and articles on the subject. Much of this literature has to do with the phenomenon of globalisation and focuses on the flows of FDI to countries such as China. However, quite some other studies are concerned with the phenomenon of regional integration and look for instance into the (determinants of the) flows of direct investment relations between the Western and Central parts of Europe.

This literature on FDI in the Central and Eastern European countries (CEECs) is quite diverse. It covers such aspects as the preferred mode (e.g. developing a greenfield site or take over of a privatised firm), the location pattern (e.g. preference for type of region e.g. urban, EU border), the indirect effects (e.g. the degree to which there are spill- overs of technology) and the effectiveness of policy instruments (e.g. tax incentives). All this work has certainly contributed to our understanding of the dynamics of FDI in the CEECs.

However there is something missing in this literature and that is the relation between the worlds of the decision taker in business on one hand and that of the policy maker in the public sector on the other hand. This book by Julia Djarova fills this gap. It does so by linking the business processes to the factors that together constitute the location profile of a country or a region.

Julia Djarova is particularly well qualified to bring this exercise to a good end, as she is able to bridge three potential gaps. First, her personal life developed in such a way that she understands equally well the realities of the East and the West. Second, her combination of academic and consultancy work makes that she naturally finds the good match between theory and practice. Finally, her work for both business and government makes that she can show where the two should meet for mutual benefit.

The results reported in this book improve our understanding of the way in which decisions on FDI are taken by multinationals and about the way public sector decision makers go about accommodating FDI. The insights that it brings are highly relevant to business and government circles alike.

Willem Molle

Chairman Board of Management ECORYS NEI
Professor Erasmus University

Introduction and Summary

1. CROSS-BORDER DECISION-MAKING

Foreign Direct Investments (FDIs) are the result of a decision-making process that takes place in companies. FDI theories and statistics help us to get a clearer picture about the role and importance of FDIs to the companies concerned. By analysing the locations FDI is directed to, we learn what makes regions or countries attractive for foreign investment. Theories, experiences and statistics help countries analyse their position in the world as they compete for foreign investments. If utilised well, this information helps countries to initiate better policies, to improve their business environment and to introduce incentives, attractive to foreign investors.

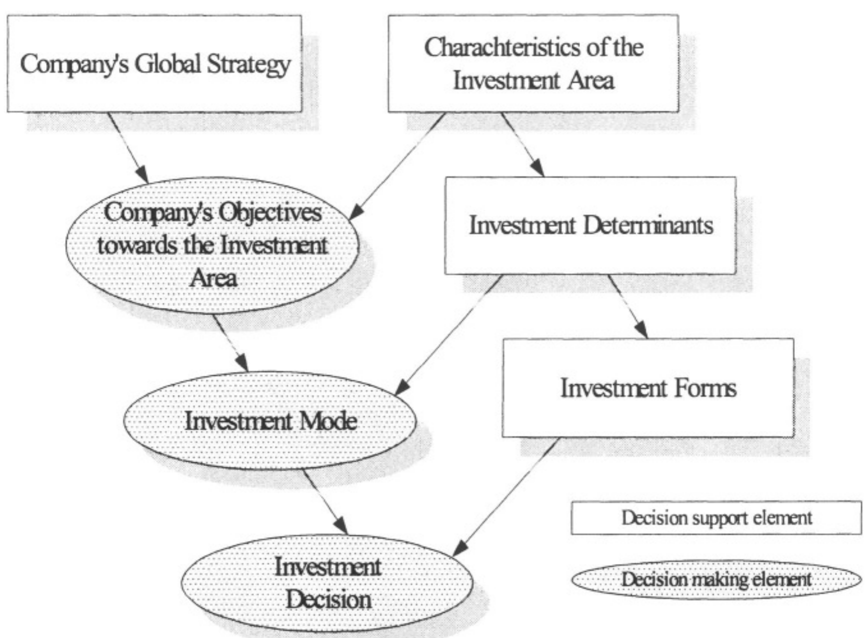
On the other side, in the boardrooms, decisions are taken differently: following theories and analysing statistics are only a small part of the decision-making. To the outside world, it often seems that companies take decisions easy, often at hoc, intuitively or randomly. In reality, decisions are bound in a logic that cannot be seen easily with an outsider's eye.

The logic of corporate investment decision-making has been and still is an intriguing research question for the author. This book offers a view that reflects two main hypotheses:

1. You cannot understand FDI trends and developments unless you understand company's motives to invest.
2. You cannot understand company's cross-border investment decision-making unless you understand what the investment area offers.

This is the reason why this book discusses cross-border investment from a national as well as a company's point of view of FDI. The complexity of analysing both sides is enforced by the fact that FDI definitions and statistical data are often not available, reliable or compatible and this puzzles the analysts. The organisation of the book takes all these aspects into account.

During more than 15 years of studying Central and Eastern Europe and East-West business undertaking, as a researcher, teacher and consultant, I have analysed a substantial number of cross-border decisions made by companies. In addition, consulting government and non-government organisations in almost all Central and Eastern European countries, I have been able to study what makes an investment area attractive to foreign companies. This is how the Cross-Border Investment Model[1] (CBIM) has been developed; it is proposed in this book to describe the decision-making process concerning a foreign investment by a company. The CBIM integrates both sides: the country's and the company's side as discussed before. The CBIM (see Figure below) structures the investment decision-making process reflecting surveyed practices.



Cross-Border Investment Model

The Cross-Border Investment Model distinguishes four inputs to the investment decision-making process:

- The global strategy of the company (this is a given quantity as far as cross-border investment is concerned);
- Characteristics of the investment area (comparative advantages of the investment area);
- Investment determinants of the investment area (specific for the investment area political, economic, business and social-cultural factors); and
- Possible forms of investment (joint venture, greenfield investment, etc.).

Consequently, the CBIM distinguishes three stages in the investment decision-making process, i.e.:

- Establishment of the company's strategic objectives towards the investment area;
- Choice of the investment mode;
- Final investment decision.

In this book the CBIM is applied to Central and Eastern Europe. The model and the results of its application are discussed in detail in Chapter 5 of Part II. Reference is provided to a number of company cases some of which are presented in Chapters 6-10.

2. ORGANISATION OF THE BOOK

The organisation of the book reflects the need of understanding of the national as well as the company's point of view on FDI. The book is divided into three parts.

2.1 FDI from a macro point of view

Part I looks at trends and developments of Foreign Direct Investment (FDI) as a function of time. The analysis is based on statistical data covering the last decade of the 20^{th} century.

In ***Chapter 1*** the following questions are analysed:

- How have regions and the countries within these regions manage to attract cross-border investments[2] in the last decade of the 20^{th} century?
- Which were the main characteristics of this process?
- Have the investment trends shown any surprises and if so what are they?
- Does the investment level in one region influence that in other regions and vice versa?

We analyse FDI in absolute terms as well as relative to population and GDP in the three main emerging markets: Asia, Latin America and Central and Eastern Europe (CEE). In each of these markets, a number of countries were selected to be included in the analysis, criteria being the size of the population, a high rating on the FDI stock inward index and, in the case of CEE, the expected accession to the European Union (EU). FDI world wide in 2000 amounted to US$ 1 500 billion (rounded figures), ten times as much as in 1990. Of this, the USA and the EU together attract a steady 70–75 percent in the decades 1980-2000. In the 1980s, the USA and the EU attracted similar amounts of FDI while after 1990, the EU share grew at the expense of the USA share reaching 54 percent of world FDI in 2000 with the USA reaching 20 percent in that year. The remaining 25–30 percent of worldwide FDI went largely to the emerging markets. FDI into these markets also experienced a growth by a factor 10 between 1990 and 2000 but this growth came to a halt after 2000.

This growth differed significantly between the three regions. Between 1993 and 1996 it was especially the Asian region that was fast growing (112% increase in FDI in 1993), after which FDI stagnated because of the Asian crisis. CEE, attracting virtually no FDI before 1990, started attracting FDI after the economic and political changes but only gained real momentum after 1996. Latin America's FDI grew by 25.7 percent in this decade, with very high growth rates from 1994–1997.

FDI data are detailed for the countries selected showing that China and to a much lesser extent Singapore and Malaysia were the main recipients in Asia, Brazil was the main recipient in Latin America, followed by Mexico and Argentina, while Poland was the main CEE recipient, taking the 7th place in the list of the largest FDI recipients of the three regions.

FDI per capita was highest in Latin America and CEE (US$ 103; average for the decade 1991–2000) against US$ 32 for Asia. Naturally, differences within the regions are large. Singapore for instance attracted US$ 1760/capita, one of the highest figures in the world. The growth of FDI/capita was very high in Latin America and CEE while modest in Asia. FDI as a percentage of GDP was 4 percent for CEE against 3 percent for Asia and Latin America (decade total). The forthcoming EU accession of the CEE countries has played an important role (Germany by comparison also attracts a relatively high amount of FDI because of the large investments in Eastern Germany).

There does not seem to be a competition between the regions when it comes to attracting FDI. Companies consider foreign investments on their own merits and postpone investments in countries or regions in crisis. This means that a decrease in FDI in one region does not automatically lead to an increase elsewhere. US companies are more eager to invest in Latin America

while EU companies are more eager to invest in CEE. FDI in Asia was picked up first by US companies, soon after the Asian crisis, because of the better economic conditions in the US when compared to the EU. Only when all regions are prospering and attractive for FDI, investors prioritise. Companies seeking market expansion look at the increasing purchasing power of the population and the general investment conditions while companies seeking resources and/or low cost production facilities focus on cost development, availability of skilled/trained personnel and also general investment conditions. This makes the risk of investing in a certain country an important consideration for FDI. Analysing the Euromoney index for country investment risk shows that in 1993 the risks in the Asian region were the highest (index 65), followed by Latin America (50) and CEE (45). The risk in CEE increased to index 70 in 1997 when the risk in the other two regions had decreased to 55. In 1998, the risks converged to 40 for all regions and since then they maintain the same values, rising again (to 55) in 2000.

EU companies pick up the highest share of FDI in all three regions, twice as much as the US in Asia (US exports being twice the size of EU exports into that region) and 50 percent more in Latin America (US exports being five times as much as EU exports). In CEE, EU companies are leading in FDI as well as exports, in both cases picking up 69 percent of the totals.

Chapter 2 pays special attention at the dynamics and the nature of FDI in Central and Eastern Europe. Economic cooperation between Western and CEE countries has developed in three specific phases:

- A phase when traditional trade dominated (before 1970s);
- A phase of emerging industrial co-operation when the first equity investments were made (1970s and 1980s);
- A phase of accelerated foreign investments, in a variety of forms (1990s).

Trade grew rapidly from almost nothing in the 1960s, following a more steady growth until 1989. The interest of the CEE countries was in machinery and the interest of Western companies was in raw materials. Trade was facilitated by the establishment of state export and import companies in CEE and by bilateral trade agreements between most Western and CEE countries (then Comecon or CMEA countries). Trade was supplemented by turnkey investments, licensing agreements and co-production activities. After 1970, economic co-operation became more intensive and more diversified, due to the relatively liberal policies and later by laws aimed at stimulating FDI. As the need for FDI and hard currency increased, the conditions and incentives for FDI were made more favourable in most countries, resulting in an increasing number of joint ventures. The total FDI in joint ventures however was limited to US$ 2.5 billion in 1989 in the six CMEA countries that permitted joint ventures (Poland, Hungary,

Czechoslovakia, Bulgaria, Romania and the Soviet Union). Germany was the largest investor in the 1980s, closely followed by Austria, Italy, the UK and the USA. The primary motivation of the Western partners was to serve new markets. However, Western companies benefited more from low costs and were unable to realise their full market ambitions. Red tape, management problems, slow market growth and an uncertain legal and political environment restricted the expansion of the number of joint ventures. After the economic and political changes in 1989-1990, the number of joint ventures rapidly increased in the former CMEA countries, doubling in 1992, growing again by 30 percent in 1993.

The changes of 1989-1990 also meant the collapse of inter-CMEA trade (especially the trade with the countries of the former Soviet Union) and the EU became the new trading partner. Trade picked up with imports from the EU exceeding exports to the EU. The trade deficit peaked in 1993 (the deficit for the CEFTA countries being ECU 5 billion) and in 1999 (ECU 22 billion). The main trading partner (import and export) was Germany (41%) followed by Austria and Italy. Machinery and electrical equipment became the largest export sector to the EU (25% of total exports of CEE countries) followed by textiles and base metals. Imports were also machinery and electrical equipment followed by transport equipment, chemicals and textiles. FDI into CEE grew from US$ 0.5 billion in 1990 to US$ 12 billion in 1995. FDI decreased in 1996 and then increased steadily to about US$ 20 billion in 2000. Poland, Hungary and the Czech Republic are front-runners in receiving FDI in both absolute and relative (to population) terms, together taking 75 percent of CEE's FDI in 2000. In terms of the ratio of FDI to GDP, Estonia (7%) and Latvia (6%) were leading the CEE countries, followed by the Czech Republic and Hungary (5%) with Poland achieving 3 percent and Slovakia ending the list with one percent FDI/GDP ratio. In sectoral terms, the secondary and tertiary sectors were most important (almost no FDI in the primary sector) with in time a shift towards the tertiary sector. The largest investors in Central and South-Eastern Europe are Germany, the USA, Austria and the Netherlands. Sweden, Denmark and Finland are the largest investors in the Baltic states. The size of the investing country and the proximity to the investing country seem to stimulate FDI. This partly explains the dominant position of Germany as an investor in CEE.

FDI has a positive impact on the economies of host countries. There are tangible effects (economic growth, increased trade, capital, wages, productivity) and intangible effects (technical and managerial know how, links to foreign markets, work attitudes). These outweigh the possible negative early consequences of FDI such as loss of jobs in, and bankruptcies of domestic companies. Greenfield investments have a larger positive effect

than takeovers. The relation of FDI and economic growth has a long-term nature while it cannot be assessed accurately as so many factors affect economic growth. In Hungary, the enterprises financed from FDI, contributed 17 percent of GDP in 1995. The figures for Poland and Estonia are 11 and 7 percent. FDI stimulates exports. For the Czech Republic the share of FDI in manufacturing export increased from about 15 percent in 1993 to 47 percent in 1998. These figures were 52 percent and 86 percent for Hungary, 36 percent and 52 percent for Poland respectively. FDI stimulates employment (in Hungary the employment in foreign financed enterprises was 15% of total employment in 1999) but it also destroys employment; the latter cannot be measured statistically. This corresponds with the high number of foreign financed companies as a percentage of total number of companies, respectively total assets (17% respectively 20% for Hungary in 1995). FDI creates jobs with local suppliers, usually after a while, as they tend to depend originally on their traditional suppliers. Suppliers often invest in CEE following their customers. Taking everything together, FDI significantly stimulates employment both quantitatively and qualitatively.

2.2 FDI from company's point of view

Part II of the book analyses the following questions:

- What are the driving forces behind company's decision to invest abroad?
- What does Central and Eastern Europe (CEE) offer to foreign investors?
- How do the interest of the companies and the attractiveness of CEE match?

Ever since Hymer and Vernon first presented their theories on foreign direct investment (FDI) in the 1960s, many authors have followed their lead. Despite the abundance of theories on FDI, no generally accepted theory has emerged so far. This lack of generally accepted theory especially concerns FDI into Central and Eastern Europe, a region that became one of the important emerging markets in the past decade. ***Chapter 3*** analyses existing theoretical approaches towards FDI with the aim to deduce their application to CEE. The chapter discusses five schools of thought that seek to explain FDI: the political economists' school, the macro-economic school, the industrial organisation school, the domestic firm school and the business analysts' school. The best-known theorist of the business analysts' school, Aharoni (Aharoni, 1966), identifies the variables "that will influence the decision process in order to explain the process itself and to be able to predict behaviour under various conditions". Aharoni elaborates mainly on the internal and external factors and argues that the decision to look abroad

is brought about by the interaction of several forces, partly environmental and partly inside the organisation. There is a group of authors who try to offer a theory of FDI that integrates the theory of international trade, the theory of domestic firm, the industrial organisation approach and the business analysts' perspective. Some models can be recognised there, which mainly discuss investment determinants or the question why a firm invests abroad. Such are the works of Dunning whose eclectic theory defines three conditions that are required if a firm is engaged in FDI: ownership advantage, international advantage and location advantage.

The major internal and external driving forces are subject of discussion of Chapter 3. These are the so-called investment objectives respectively investment determinants. Investment objectives represent the strategic part of the internal driving factors for companies to search for investment opportunities. The investment determinants of the country or region combine the most important external factors of the investment environment. These are the political, economic, business and socio-cultural factors.

The basic principles of these schools are valid for the investment process to CEE, but their application should be adapted. At the same time, the FDI experience in this region has just more than a decade of history and this hardly provides a solid basis for theoretical conclusions. In our opinion, what is most important at this stage is to gather as much empirical information concerning companies' investment behaviour in CEE as possible. This will provide a consolidation (or not) of some of the hypotheses and conclusions made by different researchers in the field.

Prior to defining the cross-border investment objectives, companies need to be convinced about the attractiveness of the investment area. This applies also to Central and Eastern Europe. ***Chapter 4*** analyses the characteristics of the region that made it / makes it attractive to Western companies. There are three main aspects that companies analyse when exploring the investment opportunities in a region or a country:

- Regional and county's macroanalysis on the basis of which investors chose a region or a country to investigate further;
- Microanalysis of the region or country;
- Specific investment opportunities.

The chapter looks at these three aspects. It elaborates on the following questions:

- How does Central and Eastern Europe place itself among other emerging markets (e.g. Asia and Latin America)?
- What is the role of the transition process to market economy and democratic society for attracting FDI into the region?
- What specific features form the FDI profile of CEE?
- Finally, how does all this reflect on the CEE investment determinants?

Central and Eastern Europe shows the best FDI figure as a percentage of GDP and it has gained the highest speed in attracting FDI. Although the region did have its ups and downs in the last decade of the 20th century, none of the countries in the region have regressed from further development. The countries have shown political stability and steady economic progress. One cannot say the same for the Asian countries that led in terms of absolute value of FDI. The Asian crisis has triggered the political as well as the economic stability of the region that only recently shows recovery signs. Latin America has approached the end of the century as the most promising region as far as FDI is concerned. The region now suffers from the spill-over effect of the Argentinean crisis that started in 2001.

The interesting fact is that the regional risks of CEE, Asia and Latin America have converged in the last years of the past decade. The three regions were judged as being economically, politically and financially equally risky. Only Central and Eastern Europe has shown an increase in investors' confidence in the period 1993–2000. The political risk of CEE has gone down while it increased in the other two regions. All three regions have become less economically attractive by the year 2000 with CEE performing better than the other regions.

Several effects of the transition process in the CEE region were of high importance to FDI. These are:

1. Irreversible economic growth.
2. Wide scope transition covering governance and enterprise restructuring, price liberalisation, introduction of trade and foreign exchange system and competition policy, banking reform and interest rate liberalisation, establishment of securities markets and non – bank financial institutions.
3. Privatisation of an unprecedented scope and scale, including large- and small-scale privatisation.
4. Development of the business environment: private sector development, improved business and investment climate.

There are also a number of characteristics that made the region difficult to invest in the beginning of the opening of the CEE markets:

– High specialisation but low efficiency;
– Low labour costs but low productivity;
– Vertically organised and highly centralised companies;
– European culture and education but no commercial attitude.

Many investment determinants of CEE have soon obtained positive values that rapidly increased the attractiveness of the region. These are:

– Market size and potential;
– Economic climate;
– Political climate;

– Geographic location and proximity;
– Historical links and Western style cultures;
– Industry specialisation;
– Skills and cost of labour;
– Fiscal regime (e.g. taxes);
– Investment incentives of CEE or Western governments/International institutions.

The stable economic growth, the unsaturated consumers' demand and the increasing purchasing power will keep CEE on the priority list of foreign investors. It is forecasted that these characteristics will remain valid for at least some 5-10 years to come. These growth factors alone, placed against the matured markets of Western Europe, make the region attractive for new investments and further expansion of the existing investments.

Although the attractiveness of CEE from a market point of view is predominant, low cost production and skilled labour can be added to the short-term attractiveness of the region. These advantages will slowly fade away as CEE countries move towards EU integration. Nonetheless, the region promises to stay a low cost production base for about at least another decade. The productivity grows faster than the wages and this makes the labour unit costs attractive for foreign investors. The relatively skilled labour, especially in engineering, as well as the high quality of education, gives CEE an additional advantage.

The geographical location of the region does not play an important role if other investment aspects are equal. Nevertheless, it is one of the priority areas for West European companies.

Chapter 5 discusses experiences of multinationals investing in Central and Eastern Europe following the Cross-Border Investment Model (CBIM). The CBIM, as an analytical tool, is close to the views of the business analysts and organisational theorists on FDI. Similarly, our approach is empirical rather than purely theoretical. Compared to the schools discussed in Chapter 3, the Cross-Border Investment Model offered in this book suggests incorporating the matching between firm's entry or expansion modes abroad and the location attractiveness into the entire investment decision process. The model follows the FDI process beyond the matching between the internal and external factors and the identification of the investment advantages.

Chapter 5 discusses the elements of the model in detail and relates them to the experiences of multinationals. We look at the global strategies of companies, bringing into discussion points of view of schools in the field. In this book we use the term "global strategy" to reflect that:

a) Multinational companies usually do not ignore any new signal from any new market: in principle, every country matters;

b) Multinational companies usually have a coherent view on their activities worldwide;
c) Multinational companies compete on the basis of their total world wide performance;
d) Multinational companies develop competitive advantages on the basis of their ability to operate worldwide;
e) Multinational companies distribute and minimise risks using their worldwide presence and expansion;
f) Multinational companies expand worldwide in order to achieve higher returns on equity and to maintain or improve their competitive positions.

The advantages of going global are defined as:

1. Getting closer to foreign customers and suppliers, as well as local knowledge and skills
2. Organising an optimal international production base
3. Achieving an efficient value chain beyond single locations/markets
4. Achieving higher defensive capabilities against competitors locally
5. Achieving higher chances for consolidation of assets
6. Achieving higher economy of scale and economy of scope effects.

Applied to Central and Eastern Europe as an investment area, the global intentions of multinationals get shaped into specific strategies and objectives. Section 4 of Chapter 5 classifies companies' global strategies in two large groups: "go global" and "invest abroad". Within these two groups, companies often pursue two concrete intentions: expand or strengthen their global market share or/and reduce costs or achieve higher efficiency. Company's investment objectives towards Central and Eastern Europe that are analysed in section 5 derive from the global and specific strategies and from the characteristics of the region as an investment area (provided in Chapter 4). As a result, investment objectives form three groups: market objectives, cost reduction objectives and pure financial objectives. Investment objectives can be realised when there are appropriate investment determinants in place. The match between objectives and determinants, specifically discussed for CEE, is paid attention in section 6. Once the company has established its investment objectives for a certain investment area, it has to select the most appropriate investment modes. These modes are derived from the investment objectives respectively the investment determinants of the area or the country. The level of control the company wishes to exercise in a cross-border investment and the level of commitment define a number of investment modes. Their definition is given in section 7 and their match with the possible investment forms is defined in section 8. The discussion on matching investment modes with investment forms is tailored to CEE and reflects the experience of multinationals. Finally we

offer five types of investment decisions towards Central and Eastern Europe that we have identified on the basis of the empirical study. These are: *offensive, defensive, consolidative, relocative and opportune.*

2.3 Case studies

Five case studies are brought to the attention of the reader of this book. They represent a mixture of experience of individual multinationals and experience of multinationals within a certain sector. Unilever, Numico, Sara Lee/Douwe Egberts and ING Bank served as individual cases. Automobile industry and international banking are the case sectors. The cases are documented and analysed using official corporate information or officially published data and information in sources outside the companies. The author interviewed top managers and experts of these companies on several occasions. The selection of the cases included in this book is the author's own choice based mainly on two criteria: how well documented the case is in order to identify as much as possible the entire decision making process in cross-border investment (in this case towards CEE); to what extent does the case present an experience that is relevant for a wider group of companies in the same or similar branch.

2.4 Background information

The book involves FDI in a broad discussion. In order to have more clarity concerning the context of FDI, a short discussion on definitions and types of investments is provided in section 1 of the ***Annex***. Since parts of this book use a substantial amount of statistical data, we provide our view on their availability, reliability and interpretation in section 2 of the same annex.

The FDI definition issue is relevant not only to economic theory as such, but also as the basis for collecting statistical information on FDI. Various institutions use various definitions forming different data basis. However, there is an agreement on what FDI is and we can understand the process of FDI to be *all capital transactions that are made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, while it is the investor's purpose to have an effective voice in the management of an enterprise.*

In an effort to overcome the problems that occur when comparing FDI statistics in general, only the figures of one international institution that specialises in the subject of FDI should be used. For most Western countries the OECD provides fairly comprehensive information regarding FDI, but in the case of CEE, the UN/UNCTAD database is a reliable and consistent source.

NOTES

[1] This model was first published in: International Studies in Management and Organisation, April 1999

[2] In this book we use the terms 'foreign investment' and cross-border investment' as synonyms.

PART I

FOREIGN DIRECT INVESTMENT AND EMERGING MARKETS

Chapter 1

The world map of investments

1. INTRODUCTION

This chapter analyses the dynamics and the nature of Foreign Direct Investment (FDI) in the world with special emphasis on three emerging markets: Asia, Latin America and Central and Eastern Europe. The analysis is based on statistical data covering the last decade of the 20^{th} century. Major trends are identified, annual changes are explained and relative FDI indicators are evaluated (section 2). The Asian crisis as an important event in the 1990s is discussed in section 3 in relation to its influence on FDI. The behaviour of the country risk indicator is studied for the period 1993-2000 in section 4. The nature of FDI, compared between the three regions, is the main discussion point of section 5.

2. GENERAL DEVELOPMENT OF WORLD FDI

Historically, foreign investments were allocated by international companies on the basis of both regional and country considerations. Over the past decade, this traditional approach has been replaced by a greater focus on individual countries. Nonetheless, the attractiveness of counties is bound by regional characteristics and developments. Therefore, one should never underestimate the importance of a region's competitive advantages in investment decisions.

This chapter offers general data on foreign direct investment (FDI) and answers the following questions:

- How have regions and the countries within these regions manage to attract investments in the last decade of the 20th century?
- Which were the main characteristics of this process?
- Have the investment trends shown any surprises and if so what are they?
- Does the investment level in one region influence that in other regions and vice versa?

The main focus point of the chapter concerns the three regions known as 'emerging markets': Asia, Latin America and Central and Eastern Europe (CEE). To simplify the analysis and allow comparisons, a representative number of approximately eight to ten countries has been selected from each region. The group of selected countries per region together attract more than 80 percent of the region's FDI inflow. Two specific selection criteria were used in order to build up the comparative samples. These were:

- A population greater than three million[1];
- Top performers on FDI inward stock index.

The data on population and the FDI inward stock[2] are those for the year 2000. The FDI inward stock index is calculated as follows:

(FDI inward stock) x (FDI inward stock per capita) / 1000

These criteria ensure that the selected countries have a number of common characteristics: they matter population wise and they receive significant amounts of FDI in absolute as well as in relative terms.

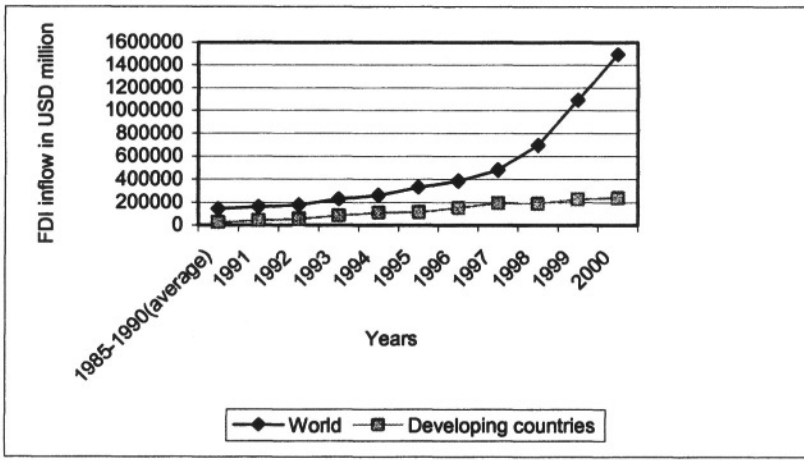
Based on these criteria the selected countries are:

- *Latin America:* Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, and Venezuela;
- *South and East Asia:* China, Indonesia, South Korea, Malaysia, the Philippines, Singapore, Thailand and Vietnam;
- *Central and Eastern Europe:* Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. These countries are in the process of accession to the European Union; they are the primary focus of discussions within this book.

Wherever appropriate not only the selected countries but also a broader concept of the regions is used[3]. However, unless stated otherwise the focus will remain on the selection.

FDI in the world has grown continuously over the period 1990-2000 and in 2000 reached the amount of US$ 1 491 934 million[4], 10.5 times more than in 1990 (see Figure 1-1). When considering the geographical map of FDI inflows, one should realise that it is quite similar for the 1980s and 1990s in relative terms (see Table 1-1). Two regions, the European Union (EU) and

the USA, have attracted on average 71 percent of the total world FDI for the period 1985-1990 and 74 percent for the year 2000. The difference between the two decades is that while the USA and the EU held a relatively equal share in the 1980s, the EU gained an advantage over the USA in the 1990s. As of 1997 FDI inflows to the EU has increased substantially. In 2000 this region attracted 54 percent of the world FDI while the USA drew in only 20 percent.



***Source:** UNCTAD data*

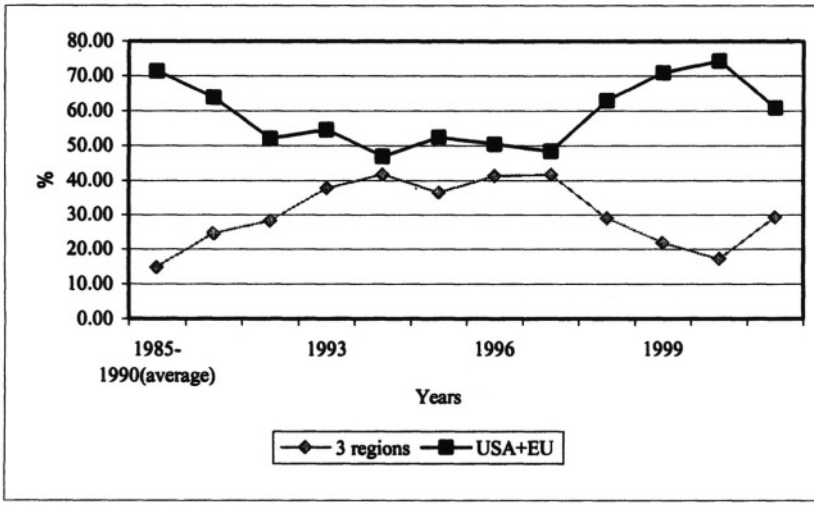
Figure 1-1. **FDI inflows[5] for 1990-2000**

The last decade of the 20th century brings to an end a period of unprecedented growth in FDI inflows to regions that were rightly called emerging markets. The region of Asia has shown a boom in 1993 (112 percent FDI growth on an annual basis) and kept a steady growth in FDI inflows until 1996 when it stagnated due to the financial crisis in the region. Latin America and Central and Eastern Europe (CEE) were the new discoveries for foreign investors. From almost no share of world FDI before 1990 the FDI entered CEE with a starting growth rate of almost 450 percent in 1991 and a follow-up growth rate of 81 percent in 1992, 60 percent in 1993 and 132 percent in 1995. This region maintained the highest growth rate over the decade, 37 percent.

Latin America, with a decade average FDI growth rate of 25.7 percent, became an investment hit in the period 1994-1997.

The three emerging markets were increasingly preferred in the years up to 1994 and maintained their attraction until 1997. This caused a substantial decrease in FDI inflows to the USA and the countries of the European Union. In this period the USA attracted on average approximately 20 percent of world investments, a level substantially lower than at the start and end of

the 1990s. The booming years of the three emerging regions show that their share of total FDI in the world was on average about 30 percent with a peak of about 46 percent in the middle of the growth period in 1995.



Source: Own calculation based on UNCTAD data

Figure 1-2. Shares of the world FDI inflows

The Asian crisis played a role in the decline of incoming investments into the region. Consequently, the level of FDI was lower at the end of the decade than at its start. To a much lesser extent than Asia, Latin America and Eastern Europe also suffered from a decline after 1997. The share of the three emerging markets dropped down to about 20 percent in the years after 1997 to give way to an increasing FDI inflow into the USA and the European Union. That is how the cycle ends after a decade, with the two most powerful regions leading once again.

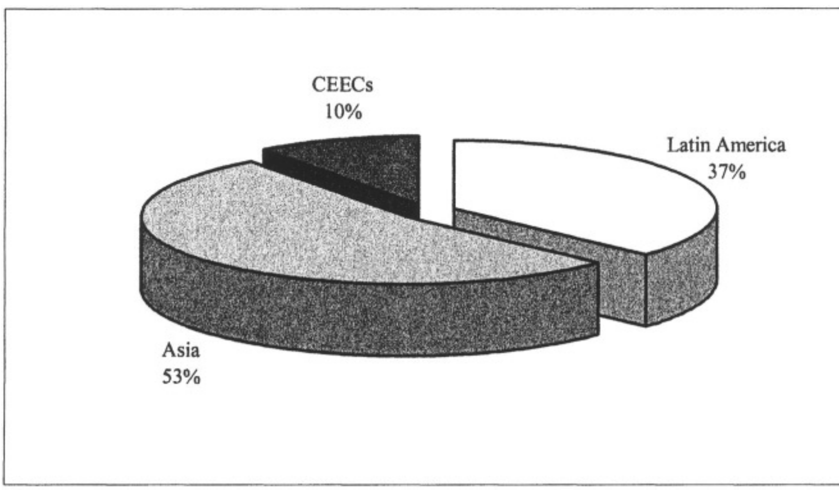
Table 1-1. Ranking of regions on the basis of FDI inflows (1 – highest rank)

Countries	1985-1990	1993	1994-1995	1996-1998	2000	1991-2000
USA	2	2	3	2	2	2
EU	1	1	1	1	1	1
Latin America	4	3	4	4	4	4
Asia	3	2	2	3	3	3
CEE	5	4	5	5	5	5

Source: Own calculations based on UNCTAD data

Within the three emerging markets, the front-runner in terms of volume of FDI inflows was Asia, with an average share of 53 percent for the last decade of the **20th** century. Its share in 1991 was 54 percent, increasing over the years to follow to almost 70 percent in 1993. Approaching the beginning of the **21st** century, Asia's share was less than 50 percent, its lowest level for more than 15 years.

Latin America performed steadily and maintained its average share for the decade of about 37 percent. Central and Eastern Europe has shown the largest expansion of its share of the total FDI of the three regions. It started with just 2 percent in 1990 and it has grown to about 12 percent in 2000, maintaining an average share of 10 percent (see Figure 1-3).



Source: Own calculations based on UNCTAD data

Figure 1-3. **Shares in the total FDI inflows to the three regions (average for 1990-2000)**

Absolute and relative FDI indicators provide more information as to how the three emerging markets have performed in attracting FDI. This will be discussed below based on data for the selected countries.

2.1 Trends in FDI inflows

The cumulative FDI inflow for the years 1991-2000 was US$ 531 451 million for Latin America, US$ 783 107 million for Asia and US$ 141 712 million for Central and Eastern Europe. Evidently, Central and Eastern Europe lagged behind significantly as the attracted amounts of FDI were several times lower than that of its competitors (see Table 1-2).

Another tendency is that the gap in FDI inflows between Latin America and Asia closes up over time, with the Asia/Latin America FDI inflows ratio

being around 1 from 1997 onwards. Substantial change can be observed in the Asia/CEE FDI inflows ratio. Being almost 11 in 1994, the Asia/CEE FDI inflows ratio has declined to around 5 in 2000, showing the increasing importance of Central and Eastern Europe compared to Asia.

Table 1-2. Comparisons between the three regions

	FDI inflows ratio[6]							
Regions	**1991**	**1994**	**1995**	**1997**	**1998**	**1999**	**2000**	**Average 1991-1999**
Latin America/ CEE	6.3	5.3	2.1	3.9	3.6	4.3	3.6	4.0
Asia/ CEE	8.7	10.9	5.1	5.5	4.3	4.1	5.0	6.5
Asia/ Latin America	1.4	2.0	2.4	1.4	1.2	0.9	1.4	1.7

Source: Own calculations based on UNCTAD data

The relatively high degree of attractiveness of the Latin American region can also be revealed from the data on population and cumulative FDI inflows (see Table 1-3[7]). The region of Latin America, accounting for 8.56 percent of the world population, gained a share of 10 percent of the world cumulative FDI inflows for 1991-2000.

Table 1-3. FDI per capita

Regions	**Population 2000**		**FDI cumulative inflows 1991-2000**	
	Million	Percent	Million US$	Percent
World	6071	100	5 291 397	100
Latin America	520	8.56	531 451	10. 04
Asia	3680	60.61	783 107	14.80
CEE	321	5.29	141 712	2.68

Source: Own calculations based on UNCTAD FDI data and UN population data

In comparison, the Asian countries with more than 60 percent of the world's population received a mere 14.8 percent of the total FDI. The countries of Central and Eastern Europe show the second best population/FDI ratio, attracting 2.64 percent of the cumulated world FDI for 1991-2000 while having a population representing only 5.43 percent of the world population.

The recipients of the largest FDI inflows are the following countries (see Table 1-4):

- Brazil, Mexico and Argentina in Latin America;
- China, Singapore and Malaysia in Asia;
- Poland, Hungary and the Czech Republic in Central and Eastern Europe.

Table 1-4. Top 10 countries in the three regions by absolute values for FDI

	FDI cumulative inflow 1991-2000 (million US$)	
1	China	322 012
2	Brazil	134 416
3	Mexico	92 237
4	Argentina	73 389
5	Singapore	62 486
6	Malaysia	48 413
7	*Poland*	*40 601*
8	Chile	35 105
9	Korea, Republic of	35 077
10	Thailand	31 678

Source: Based on UNCTAD data

Within the list of all selected countries, Poland ranks seventh, the Czech Republic twelfth and Hungary thirteenth by volume of cumulative FDI inflow. Representing Asia, China ranks first and Thailand tenth. Three out of the first five positions belong to the Latin American region, held by Brazil, Mexico, and Argentina.

2.2 Annual change of FDI inflows

CEE with an average annual increase of 26.9 percent is the region with the fastest development in FDI. Latin America follows closely with 25.8 percent. The change in the Asian annual FDI inflows between 1991 and 1999 was substantially lower than that of the other two regions. This was influenced primarily by the Asian crisis and the stagnant FDI inflows into Asia that followed. The fastest growth of FDI inflows to CEE can be explained by the low starting position of the region in 1991 compared to the other two emerging markets. In 1991 Central and Eastern Europe was attracting less than 10 percent of the FDI inflows to Asia, while by 2000 this figure had increased to more than 20 percent. The Latin American region was receiving a volume of FDI close to 70 percent of that received by Asia

at the start of the 1990s. As of 1999, the region had become as attractive as Asia. Finally, investors have been exploring Asian FDI opportunities from the 1970s onwards while an investment boom to the other two regions occurred only in the last decade of the 20th century.

Table 1-5. Annual changes in attracting FDI

	Annual change average 1991-2000 (percent)
Lithuania	57.5
Poland	47.0
Brazil	45.8
Romania	43.4
Slovak Republic	43.2
Latvia	39.2
Bulgaria	37.8
China	28.2
Czech Republic	26.5
CEE	**26.9**
Latin America	**22.2**
Asia	**13.8**

Source: own calculation based on UNCTAD data

Looking at the figures for each year of the period, one notices that Central and Eastern Europe and Latin America have progressed steadily during the entire period, while Asia had its ups and downs. Between 1992 and the Asian crisis, Asia doubled the level of its FDI. However by 1998 it was experiencing a negative growth.

The years between 1996 and 2000 were years of rapid growth in FDI inflows to Central and Eastern Europe and Latin America. In terms of the volume of FDI, these two regions did not show a negative influence of the Asian crisis.

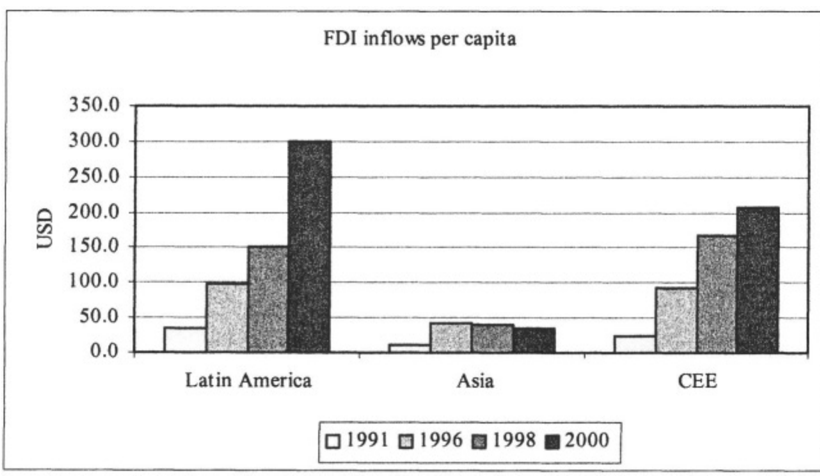
The annual increase of FDI inflows to some countries is impressive. Peru, Lithuania, Poland, Brazil and Romania experienced more than a 50 percent growth in FDI inflows on average, a pace of development two times higher than the world average. Asian countries that showed a relatively high average growth rate between 1991 and 1999 are China (32 percent), Korea (31 percent) and Vietnam (27.6 percent).

Although FDI into CEE represent only about 3 percent of the world total investment, the pace of attracting foreign investments is impressive especially in a number of countries. Only some Latin American countries matched this pace. At the same time, FDI to Latin America represented 11

percent of the total world investments. The picture changes slightly when relative FDI indicators are discussed.

2.3 Relative FDI indicators

The regions of Latin America and Central and Eastern Europe showed the highest FDI per capita for the period 1991-2000 on average (US$ 103). Asian countries, with US$ 32 of FDI per capita, were far behind, even though Singapore (US$ 1760) is an exception; this country in fact outperformed many developed countries (see Figure 1-4). Among the list of the best performers were Chile, Malaysia, the Czech Republic and Hungary with more than US$ 200 of FDI per capita. With the exception of Bulgaria, Lithuania and Romania, all CEE accession countries demonstrated a better FDI/capita ratio than Greece (about US$ 80) and Italy (about US$ 90) for instance. For Germany this ratio, which was on average US$ 450 throughout the period, increased substantially at the end of the decade due to large investments in the Eastern part of the country.



Source: Based on UNCTAD and UN data

Figure 1-4. **FDI inflows per capita**

Once again, Latin America and CEE both experienced rapid growth of the FDI/capita indicator over the years. Latin America started with US$ 33 and CEE with US$ 24 in 1991. However, Central and Eastern Europe enjoyed faster growth. The Asian region managed to triple the ratio and maintained a stable growth level in the last years of the period.

However, when compared on the FDI/GDP ratio, the picture is different. The countries of Central and Eastern Europe exhibited the highest (4 percent

as average for the period) value of this indicator and reached more than 5 percent by the year 2000. The Latin American region more than doubled the FDI/GDP ratio and reached just over 4 percent at the end of the period. Asia made a better start in 1991 but experienced modest growth over the period, maintaining a value of slightly more than 3 percent on average. The best performers in all three regions were Chile, Vietnam, Singapore and Malaysia, Estonia and the Czech Republic.

Table 1-6. Regions comparative table[8]

	FDI inflows (1991-2000)	FDI annual change (1991-2000)	FDI per capita (1991-2000)	FDI as a percentage of GDP (1991-2000)
Latin America	531 451	22	103	3
Asia	783 107	14	32	3
CEE	141 712	27	103	4

Compared on the basis of both absolute and relative FDI indicators, the region of Central and Eastern Europe demonstrated leadership. Cumulative FDI inflow was the only indicator in which this region was outperformed by Asia and Latin America. At the same time, this indicator is largely related to the size of the market, which is much smaller in CEE than in the other two regions.

The accession of the 10 CEE countries, due in mid-2004 and in 2007, is expected to have a positive effect on FDI inflows. The CEE economies have shown an average annual GDP growth rate of about 3 percent for 1991-2000 against 2.5 percent recorded for the EU member states. The countries in accession will continue outperforming the EU region in growth terms and will show about 1.7 percent additional yearly growth of GDP as of 2004. This indicator will be at the level of 0.6 percent for the 15 EU countries. The growth prospects of CEE, in addition to a number of other investment determinants that will stay stable in the next decade, allow us to make an optimistic forecast concerning FDI inflows to this region. Our prediction is that FDI inflows will follow the growth pattern from the last 2-3 years of the last decade of the 20^{th} century for another 7-10 years to come.

As for the other two regions, the recent developments in Latin America have influenced its leading role in FDI as well as the prospect that the region could become the front-running emerging market in the nearby future. If dogged by the financial crisis that initially started in Argentina, Latin America will most probably experience similar developments as Asia did between 1997-1998. The Asian financial crisis can provide useful lessons for

Latin America in terms of consequences for foreign investments. The only consideration that differs is the development of the world economy in general and that of the USA in particular. This is because the EU and the USA are the two largest investors in the two regions. The Asian crisis came at a time when the USA was economically strong and the EU experienced a slight decline in economic growth. Unfortunately, the Argentine crisis overlaps with an economic recession in the EU and a much stronger recession in the USA. A severe financial crisis cannot only reverse the growth of the FDI inflows for the period of the crisis, but to a large extent restrict it to a marginal level in the years to follow.

3. THE ASIAN CRISIS AND CORRELATION BETWEEN THE REGIONS

Looking at the data regarding FDI inflows in 1997 and 1998 the fall in the level of FDI in Asia is obvious. FDI in the eight analysed countries of this region declined by 8.5 percent in 1998 while the region's annual average increase is about 14 percent.[9] The fall was in all likelihood a direct effect of the financial crises in 1997. Since all these countries are amongst the most important recipients of FDI, they are very representative as far as the impact analysis of the crisis on the Asian FDI is concerned. The amount of FDI flowing into the Asian region has decreased steadily during the years after the crisis reaching 1995 levels in 2001.

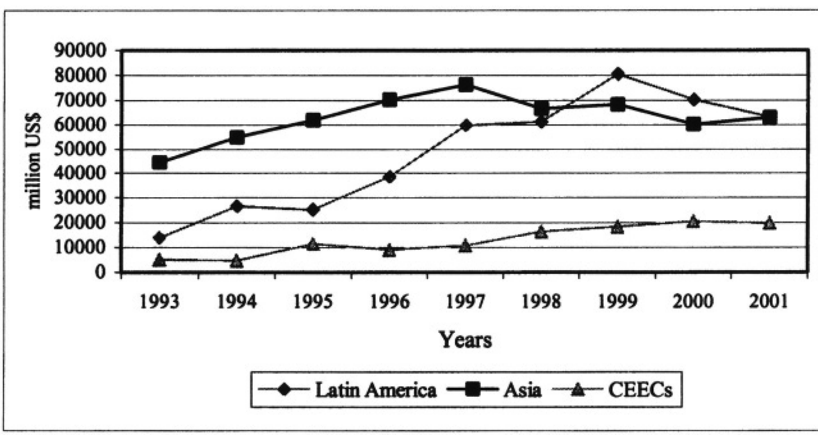
The Asian countries most affected by the crisis were Indonesia, Korea, Malaysia, the Philippines and Thailand. At the same time, some of these countries attracted higher levels of FDI in 1998 than before. The level of FDI in Korea increased by approximately 50 percent and in Thailand and the Philippines by as much as 70 percent in 1998.

According to a survey conducted by UNCTAD and the International Chamber of Commerce in 1997[10], 81 percent of the investors declared their confidence in the region as unchanged in a long-term perspective. Foreign investors have signalled a stable trust in the region. They considered instead new opportunities created by the crisis. Investors, looking for market entry and expansion found the effect of the exchange-rate depreciations, the decreased costs of production and the lower prices of assets and equity a unique opportunity. The cost advantage was particularly interesting for export-oriented investors. Many multinationals considered the increased "international cost competitiveness" as an opportunity to strengthen their position in the region. In addition the depreciation of the local currency made exports from Asia more attractive. Investors that were outsourcing to the region benefited. Switching from domestic sales to exports has proved

relatively easy for multinationals due to their extensive international networks.

According to Damon Bristow (1998), American companies moved into after-crisis Asia quicker than investors from the EU. Bristow gave a number of reasons for this. The American economy continued to boom while growth in Europe declined. European investors focused their attention on Central and Eastern Europe. The fact that the USA, as the biggest trading partner of and foreign investor into most of the Asian countries, had built up closer business ties is also a significant factor.

The other regions reacted differently to the Asian crisis as the figures show (see Figure 1-5). In 1998 Latin America faced the lowest increase in FDI inflow (1.6%) since 1991 with FDI inflows decreasing in five of the eight Latin American countries analysed. In the same year the amount of FDI invested in Central and Eastern Europe increased by 48 percent.

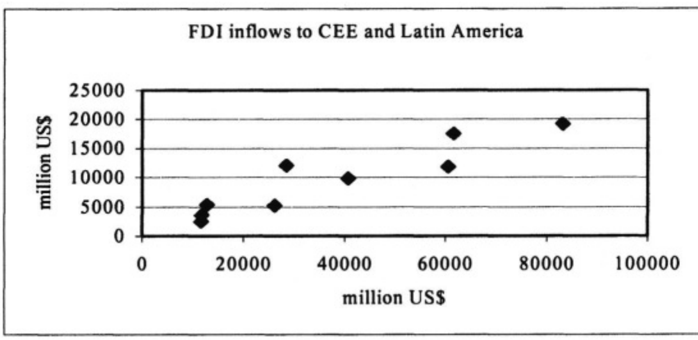


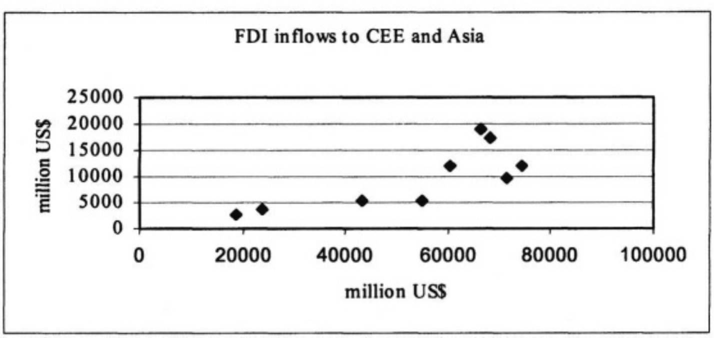
Source: UNCTAD data; for the selected countries

Figure 1-5. **FDI inflows to the three regions**

UNCTAD (1999) argues that the Asian crisis has not exerted much impact on FDI inflows into the Latin American and Central and Eastern European regions. We agree with this statement to a certain extent. The basic principle of foreign investors, drawn from the statistics as well as from case studies, is to consider each region separately. Joint considerations come in times when investments have to be prioritised due to the financial limitations of the investor. These priorities are found in the short-term agenda of companies rather than in their long-term investment objectives. At the same time, other world developments at the time of the crisis could have influenced investment priorities. This is the case with the rapid transformation of Central and Eastern Europe at the time of the Asian crisis. The years 1997 and 1998 present the most intensive period of change for the

countries, especially in Central Europe where the privatisation process was moving at an unprecedented pace. Such a scale of privatisation occurs only rarely and this has the power to attract FDI away from other regions. There was a large increase in FDI inflows into CEE in 1998 due to the fact that the transition processes in the region had by then gained substantial momentum. The EU countries in particular, which are physically close to the region, have taken advantage of this development.





Source: UNCTAD data; for the selected countries

Figure 1-6 & 1-7. **Tracing a correlation between the regions**

Without going into a regression analysis, the scatter diagrams (see Figures 1-6 and 1-7) indicate that there is no significant negative relationship between FDI inflows into CEE and Latin America respectively between CEE and Asia. There is even a positive correlation scathed between the FDI into Latin America and into CEE.

The UNCTAD/ICC global survey (March 1998) reported that 90 percent of the respondents indicated that they plan to increase their investments into Latin America and Central and Eastern Europe. Nonetheless, they emphasise that they do not intend to reduce their investments to the region of Asia as a result.[11]

Multinationals look at all regions within their strategic agenda. Switching from one region to another is not permanent and is company and/or investment project related. Resource-seeking investors, for instance, are limited to the location opportunities. Asset seeking companies could find attractive one-off opportunities in crisis regions. The same applies to low-cost seekers especially when low costs are based on efficiency of operations.

Mostly investors that aim at market expansion will reconsider their strategy towards crisis regions/countries. The size of their markets and especially their purchasing power define their choice. Investors with short- to mid-term objectives may make a profit from operations in crisis economies. Companies with long-term intentions will rather have a stand-by attitude. Many such companies considered Central and Eastern Europe during the time of the Asian crisis as a stable investment region.

A few important conclusions can be emphasised here:

- FDI into the Asian region was affected by the crisis in 1997 and as a result an overall decline in FDI inflows occurred in 1998 and 1999;
- This decline was, however, not as extensive as expected with several countries even experiencing very high growth in FDI;
- FDI into Latin America slowed down in 1998. It is questionable whether this is directly related to the Asian crisis;
- In 1998 Central and Eastern Europe received an amount of FDI almost 50 percent larger than that in 1997. It seems that the region was not influenced by the economic developments in Asia. On the contrary, one can argue that it has benefited from it.

4. COUNTRY RISK

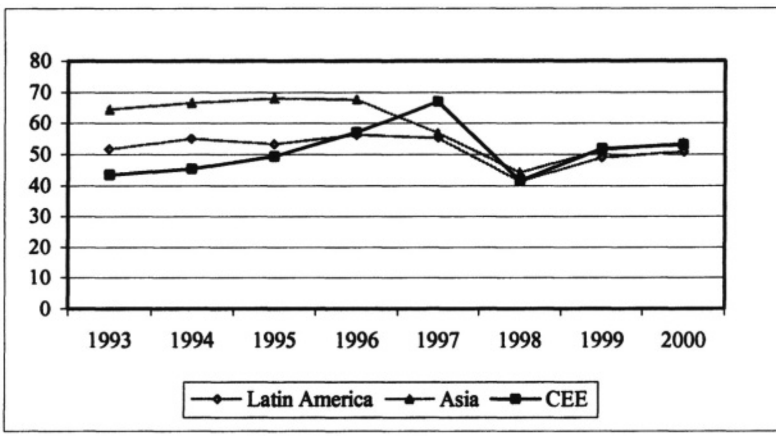
There are several institutions that estimate a country's risk based on their own methodologies. The Euromoney country risk method is quite exhaustive, accommodating a large number of political and economic indicators. The advantage of the Euromoney risk assessment is that it can be followed for a series of years and therefore provides for greater comparisons. The following categories of indicators are considered by the Euromoney country risk method:

- Economic data (25 percent weight);
- Political risk (25 percent);
- Debt indicators (10 percent);
- Debts in default or rescheduled (10 percent);
- Credit rating (10 percent);
- Access to bank finance (5 percent);
- Access to short term finance (5 percent);

– Access to international bond and syndicated loan market (5 percent);
– Access to and discount on forfeiting (5 percent).

For the purpose of comparison, the political and the economic risks that together form half of the total risk indicator of a country have been analysed. The data are from 1993 onwards, due to the fact that Euromoney revised its method in this year.

Calculations of an average region's risk based on the data for the selected countries show a convergence of all three regions over time (see Figure 1-8). There was no significant difference between them at the end of the period observed (2000), so the risk that investors had to bear when investing in the three regions was approximately the same.



Source: Euromoney (high index means high risk)

Figure 1-8. Regions risk total[12]

Political and economic risks appear to have behaved similarly. Both indicators were the lowest for the region of CEE and the highest for Asia at the beginning of the period (1993). While their values grew for CEE, especially between 1995-1998, reaching, in 1996, the level of those of the Asian region, the risk in Asia increased. Latin America did not show an impressive change in its risk indicators until 1998. It then demonstrated the best economic performance of all regions; however, it managed to sustain it for only one year. It is disappointing to notice that the political risk of the three regions at the end of the 20th century was at the level of 1993. The economic performance was more encouraging, having been substantially improved over the last three years of the decade.

The best performer of all the countries in the three regions was Singapore, reaching 89 points on average.[13] Ranked by the total average score the other countries of Asia that are relatively safe for investment have

been Korea, Chile, Malaysia and Thailand. The safest countries for investment from the Latin American region were Chile and Colombia. Some of the countries of Central and Eastern Europe had a very poor score (e.g. Bulgaria and Romania). However the Czech Republic, Hungary and Poland were above the average for all the countries in all three regions (see Table 1-7 for top 10 countries).

The highest results for Asia fit well into the picture of the FDI inflows in absolute terms. However, as mentioned already the Asian FDI situation has not been as strong if viewed on the basis of relative indicators. This suggests that there is a correlation between country risk and FDI inflows in absolute terms but not between country risk and any other FDI indicator.

Table 1-7. Top 10 countries ranked on country risk

		Average 1993-2000		
		Political Risk	Economic Performance	Total score
1	Singapore	22.3	20.3	89.1
2	Korea South	19.2	16.7	73.4
3	Chile	18.8	15.8	70.8
4	Malaysia	18.8	15.0	67.8
5	Thailand	17.4	14.3	66.5
6	Czech Republic	17.6	15.1	65.5
7	China	18.3	15.0	65.2
8	Hungary	16.6	14.3	63.3
9	Indonesia	14.6	12.5	56.4
10	Colombia	13.6	12.3	56.4

Source: Euromoney

5. THE NATURE OF FDI

5.1 Geographical presence

The European Union has been leading the way in developing direct investment relationships with all emerging markets. The EU has been particularly dominant in the countries of Central and Eastern Europe where it has also gained a leading position as a main trade partner. The United States kept its interests closer to home, in the region of Latin America. Parallel to the trade links from the beginning of the 1990s, FDI relationships picked up

in the middle of the decade. As far as Asia is concerned, the financial crisis changed the position of the EU, reason for the region to re-direct its FDI to Central and Eastern Europe (see section 3 of this chapter).

Looking at the FDI outflow structures of the United States and the European Union, a few observations can be made. Latin America was the obvious priority destination for US investors (more than 65 percent of the total FDI outflow to the three regions[14]), followed by Asia (about 28%).

Table 1-8. Geographic breakdown of FDI and export flows

	FDI origin	Export	FDI origin	Export	FDI origin	Export
To: / *From:*	Asia	Asia	Latin America	Latin America	CEE	CEE
United States	24%	20%	34%	59%	21%	3%
European Union	41%	11%	49%	12%	69%	69%
Japan	7%	13%	7%	12%	5%	-
Asia	17%	41%	-	-	-	-
Latin America	-	-	-	16%	-	-
CEE	-	-	-		-	21%

Source: UNCTAD FDI data and IMF data on export[15]; **Empty cells correspond to an insufficient contribution to the total picture**

Only about three percent has gone to the CEE region. Contrary to the latter, the EU FDI outflows to CEE represented more than 25 percent of the total for the three regions, a share almost equal to that of Asia. Latin America has enjoyed more attention and the share of FDI outflows from the EU was 47 percent on average. The geographical proximity, or as it is referred to by Hunya (2000), a gravity-type relationship between host and home countries, influences, to a certain extent, the regional distribution of FDI. At the same time, the long-term intention of investors is to be present in all regions.

5.2 Sectoral distribution

The sectoral distribution of FDI inward stock in the developed countries, the three regions and taking into consideration the overall world prospect, provides us with a number of interesting observations. These are:

- There was a tendency around the world towards an increasing importance of the service sector (e.g. tertiary sector). The secondary

and the tertiary sectors were approximately 40 and 50 percent of the total FDI inward stock in the world, respectively.[16] The primary sector attracted just more than six percent and this was in activities primarily related to exploration. Agriculture was not attractive to foreign investors.

– Latin America and Central and Eastern Europe achieved a very high level of FDI in the tertiary sector when compared to the level achieved by the developed countries. The share of the services was just above 50 percent in both regions and more than 55 percent in the developed countries.

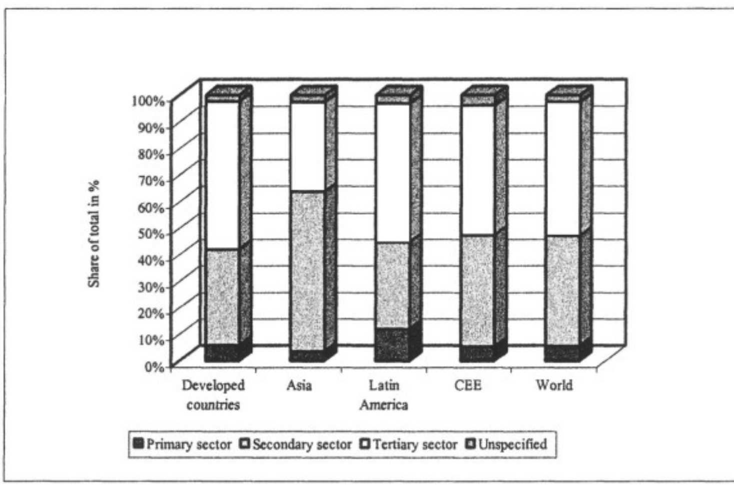


Figure 1-9. **FDI inward stock by industry and region (1999)**[17]

– Asia attracted 33.6 percent of the total FDI into the service industry and 60.2 percent into the manufacturing sector. This picture deviates from any other trend in other regions and in the world in general. In the tertiary sector, the business services held a substantial share that was more than half of the total foreign capital invested in the service industry. On the other hand, financial intermediaries and other financial services held a low share of 1.8 percent.

– Business activities were also the most attractive part of the tertiary sector in Latin America (14.3 percent). But they certainly had a low priority as far as CEE is concerned (3.3 percent).

– Financial services were the most attractive activities in developed countries, receiving one third of all FDI in the tertiary sector. Financial services were also high on the list in Latin America and Central and Eastern Europe where they accounted for 12.3 and 13.6 percent of the FDI in the service sector, respectively.

- Trade also attracted investment, though to a limited extent. Its share was highest for the developed countries and CEE, representing approximately one quarter of the FDI in the tertiary sector. The share was low for Latin America (6.2%) and especially Asia (4.1%). The value of this indicator for the world was 10.5 percent.
- The regions showed opposite trends in some of the sub-sectors of the tertiary sector. Latin America attracted 11.2 percent in the public utilities sector (e.g. electricity, gas, water). No other region received a substantial inflow in this sector. The transport and communications sectors of Central and Eastern Europe proved to be attractive (9.8%).
- Regarding the secondary sector, the regions performed quite differently too. Central and Eastern Europe attracted 11.7 percent in food, beverages and tobacco, representing more than a quarter of the total FDI stock in the secondary sector. This sub-sector has second priority in Latin America and it was very low on the list for the other regions and the world as a whole. The electrical and electronic equipment sector in Asia was the most attractive sector regarding FDI. This sector received little attention in CEE and almost none in Latin America. Motor vehicles and transport equipment was second on the list for CEE within the manufacturing industries. This related well to the high investments in the transport service sector. Machinery and equipment was also an area in which foreign investors preferred the CEE region over Latin America and the developed countries and especially over Asia.
- There was one interest of FDI that was common in all regions and that was chemicals and chemical products. The highest shares of FDI, as a percentage of the totals for the secondary sector, could be found in the developed countries and in Latin America, followed by CEE and Asia.

Looking at the sectoral allocation of FDI outflows from the developed countries, it is clear that these countries were locating their mining, quarrying and petroleum exploration activities close to the source. A great share of these FDIs went to Latin America but also to the developed countries themselves. A quarter of FDI in the manufacturing industry was directed towards chemicals and chemical products. It appears to be one of the most international industries spread all over the regions of the world. The share of the food, beverages and tobacco sub-sector, as well as of the motor vehicles and other transport equipment was substantial. Very little FDI in these industries went to Asia. Most of it was attracted by CEE, followed by Latin America and to a lesser extent, other developed countries.

With regard to the picture of FDI inward stock for the tertiary sector, the developed countries invested substantially in financial services abroad. This

represented 50 percent of their total FDI outward stock. An essential part went to other developed countries, to CEE and to Latin America (in that order). Followed by transport, storage and communication, business services was the sector that developed countries held as their second priority for investment abroad.

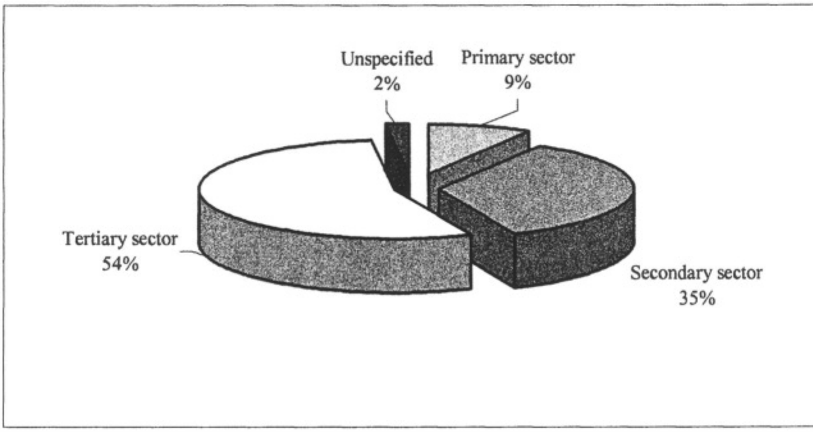


Figure 1-10. **FDI outflow stock of developed countries (1999)**[18]

5.3 The nature of FDI in Latin America

As a result of poor economic performance as well as debt crises in the region, direct inward investment into Latin America was considerably insufficient between the 1970s and early 1980s. This period is therefore often referred to as a *"lost decade"*. Similarly to Central and Eastern Europe, the FDI boom in the Latin American region took place in the last decade of the 20th century. Two factors have played an important role: the spread of the globalisation process all over the world and national economic policies. In the context of globalisation, FDI inflow into developing countries has been following a growing trend. Latin American policies towards economic reforms, liberalisation and most of all, privatisation have been the other significant factors that increased the attractiveness of the region to foreign investors. Latin American countries experienced very high growth in GDP during the decade and that was partly a reason for and partly a consequence of higher FDI inflows. Within the region Brazil, Argentina and Mexico achieved the highest FDI shares.

According to ECLAC (1999)[19] three main objectives of FDI could be identified in the manufacturing industry of Latin America. These were:

- Efficiency-seeking objectives aimed at achieving internationally integrated production;

- Seeking access to national and sub-regional markets;
- Seeking access to assets of strategic importance.

Efficiency-seeking investments in manufacturing have been mainly found in Mexico, which became one of the largest production bases for export to the United States, very much stimulated by the North American Free Trade Agreement (NAFTA). Export-oriented assemblies for international companies were also placed in other countries of the region. For instance, one third of the total FDI flows into Costa Rica went into electronics in 1998.[20]

Within the services sector, the market-access objective and the access to strategic assets were significantly predominant. The privatisation wave at the beginning of the decade gave a strong push to foreign investors buying public utilities, as well as acquiring banks and media companies.

Table 1-9. Strategies of multinationals in Latin America in the 1990s

Investment objectives	*Primary sector*	*Secondary sector*	*Tertiary sector*
Resource seeking	Mining, gas and petroleum, minerals	Chemicals and chemical products	Tourism
Assets seeking			Public utilities
Efficiency seeking		Chemicals and chemical products, automotive, electronics	Tourism
Market access seeking		Food, beverages, and tobacco, automotive, electronics,	Trade, finance services, gas distribution, electricity production and distribution, telecommunications

Source: Based on data of UNCTAD

Some of the investments were also motivated by a raw materials-seeking objective.[21] Mining is a traditional sector for foreign investors in the region. Local oil and gas industries complemented the strong flow into the tertiary sector. Since the resource-seeking objective is country related, countries that are rich in raw materials hardly compete with each other for foreign investment. Important country-investors into Latin America were the United States, Spain and Portugal. This demonstrates that distance, traditional historic and cultural links, as well as economic, cultural and often political influence do play an important role when choosing an investment destination. At the same time the UK, France and Germany were also among the largest EU investors in the region. Spain and Portugal participated only modestly in the total FDI into Central and Eastern Europe.

The US was a substantial investor in Asia and ranked fourth or fifth on the list of investors in CEE. The UK, France and Germany were substantial

investors in the CEE region as well as in Asia. It seems that traditionally large country-investors do aim to maintain a region-wide FDI portfolio independently of the distance, historic or cultural links.

5.4 The nature of FDI in Asia

FDI in Asia has a longer history than that in Latin America and Central and Eastern Europe. FDI expansion was noticeable by the 1980s and the trend of fast growth was sustained in the beginning of the 1990s. As discussed before, the Asian financial crisis reversed this trend.

According to Sikorski and Menkhoff (2000[22]) the *"flying geese"* pattern can be observed in the behaviour of FDI in Asia. This means that less-advanced economies are often low-cost export platforms for advanced economies. The basic principle of the "flying geese" behaviour is the shift from labour-intensive towards capital-intensive manufacturing over time. This shift follows the economic development of the host countries. The countries from the Asian region have developed unequally. The first to accommodate the "flying geese" behaviour of foreign investors were the so-called Newly Industrialised Economies (NIEs). These are Hong Kong, Singapore, South Korea and Taiwan. They offered low-cost production combined with a high level of labour discipline, a good business attitude and increasing productivity. Japan demonstrated typical "flying geese" behaviour in the 1960s when it transferred its textile production to the NIEs. Japan itself turned to more sophisticated industries such as automotive and electronics. By the 1980s, foreign investors moved from the NIEs further on to China and later on to other Asian countries like India, Malaysia and Vietnam. This move followed the economic development in the NIEs that affected the level of labour costs and services. As a consequence, NIEs re-allocated their resources into more capital-intensive industries using the less-advanced countries in the region as cheap input-platforms for their production. The "flying geese" pattern suggests that the main investment objective of foreign companies investing in Asia is to seek efficiency. Many authors argue that Asian FDIs are based on outsourcing the production of goods that are subsequently exported to other world markets.

The OECD (1999) analysed four important destinations for FDI in Asia – Indonesia, Malaysia, the Philippines and Thailand. The findings show that there was a very strong correlation between exports and FDI, which indicates export-oriented FDI. This is confirmed by the export propensity[23] figures of foreign affiliates in the Asian countries.[24] In the middle of the decade in question, Japanese affiliates had an export propensity of about 76 percent in the primary sector, 40 percent in the secondary sector and 25 percent in the tertiary sector. The American companies in the region were

exporting approximately 42 percent of their total sales of manufactured products and more than 50 percent of the electrical equipment. These data confirm the importance of the efficiency-seeking investment objective of FDI.

Although the table illustrates the fact that the export propensity of Japanese and American FDI was very high, more detailed data would be required in order to extensively describe the nature and patterns of FDI into Asia.

Table 1-10. FDI factors

Indicators	FDI
Home country GDP	+
Home country population	-
Host country GDP	0
Host country population	0
Trade (between the host and the home country)	++
Distance (between the host and the home country)	0

Source: Stone S., Jeon B. N. (1999)[25]

A study conducted by Susan Stone and Bang Nam Jeon (1999) also appears to be very relevant to the nature of FDI in Asia. The authors analysed FDI inflows in several Asian countries and derived a few relationships. The results are summarised in Table 1-10. The clear correlation between trade and FDI suggests that FDI is complementary to trade. This indicates that the investment motivation lies in the search for cheap inputs to production rather than with the intention of market penetration. The negative link between FDI and the home country population implies that investment is more likely to originate from small countries that have limited opportunities for further increases in efficiency. The fact that the host country population does not matter leads to the conclusion that market-seeking investments have a lower priority. The neutral relationship between FDI and the host country's GDP supports this conclusion. As found by UNCTAD (1998), the market size and per capita income in host countries are among the principal determinants of market-seeking FDI.

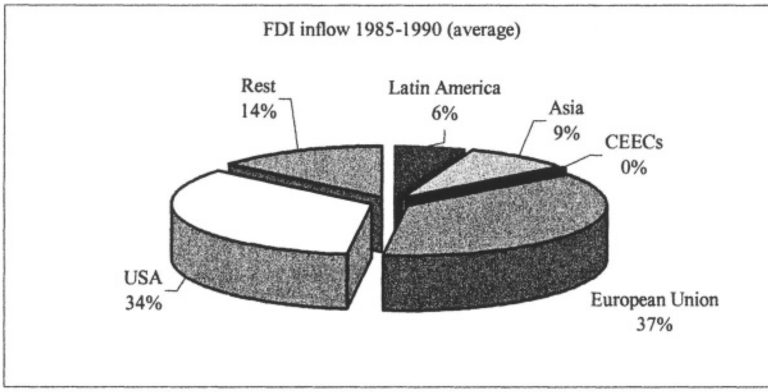
The most important investors in Asia were Japan, the US and the EU. NIEs played a substantial role in the intra-regional FDI. The majority of FDI into the region had an efficiency-seeking objective.

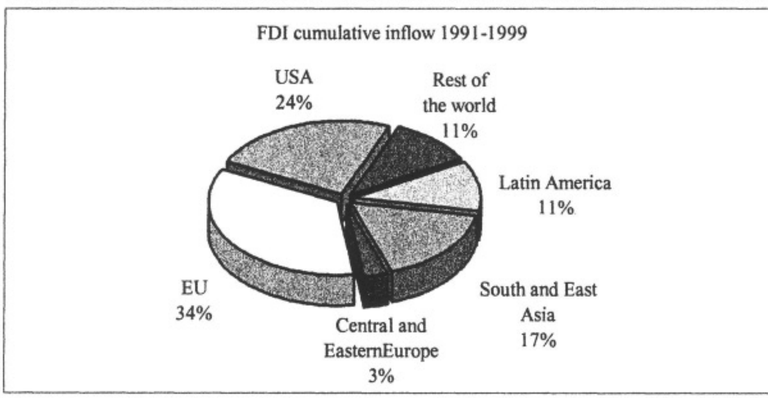
The nature and specifics of FDI in Central and Eastern Europe will receive particular attention in Chapter 2.

6. CONCLUSIONS

Analysing the quantitative aspects of FDI in the three regions, Latin America, Asia and Central and Eastern Europe, for the last decade of the 20th century it can be concluded that:

- Highly industrialised countries have invested more in their own countries than in emerging markets.
- Central and Eastern Europe exhibited the most unprecedented developments in FDI in comparison to Asia and Latin America.
- Asia was the largest recipient of FDI inflows measured in absolute terms, mainly due to the more favourable starting position of the region. However, there was a tendency that Asia is losing its supreme position and that it is becoming as attractive as Latin America and Central and Eastern Europe.
- The region of Latin America developed very fast in terms of FDI as reflected in the high level of interest from investors. Being the best performer not so long ago, Latin America has been dragged back by the severe economic and financial crisis it suffered at the beginning of the 21st century.
- Investors have begun to explore the large potential for FDI in Central and Eastern Europe. In terms of relative indicators, FDI in Central and Eastern Europe has outperformed FDI in Asia.
- The Asian crisis was responsible for the overall decline in FDI in the region even though investors' loss of confidence was much less than expected. An implication of the Asian crisis on FDI flow to the other regions cannot be clearly distinguished.
- There was a clear convergence between regions as far as the country risk rating is concerned. This convergence has resulted in the present situation where all three regions are equally risky or equally attractive as far as political and economic developments are concerned.
- It seems that investors do not substitute one region with another. The trends based on data lend more support to the conclusion that regions are not replaceable as far as FDI is concerned.
- FDI into Asia was mostly motivated by efficiency-seeking objectives.
- FDI into Latin America had market seeking as well as efficiency-seeking objectives. Opportunities for obtaining strategic assets were also part of the investment objectives.





NOTES

[1] Some countries such as Estonia, Latvia and Slovenia have a population less than three million people. Nevertheless they are included for the reason to complete the group of CEE countries in accession that are primarily discussed in this book.

[2] Foreign direct investment (FDI) inwards stock is the value of the share of the capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprise.

[3] UNCTAD classification of regions

[4] All figures quoted here are based on calculations on UNCTAD data. Data for 1985-1990 are average; this for 1991, 1992 and 1993 are from World Investment Report 1997; data for 1994-2000 are from World Investment Report 2000, data for 2000 are from the UNCTAD FDI statistics published in 2003 (stats.unctad.org/fdi/eng). Central and Eastern Europe, Latin America and South East Asia as regions are understood as defined by the World Investment Report.

[5] Inflows of the foreign direct investment (FDI) are comprised of capital received from an FDI enterprise by a foreign direct investor. There are three components in FDI: equity capital, reinvested earnings and itra-company loans (UNCTAD definition)

[6] FDI inflows in region 1/FDI inflows in region 2

[7] Countries include:

Latin America: Antigua and Barbuda, Argentina, the Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominica, the Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Haiti, Honduras, Jamaica, Mexico, Netherlands Antilles, Nicaragua, Panama, Paraguay, Peru, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago, Uruguay, Venezuela

Asia: Bangladesh, Cambodia, China, Hong Kong, China, India, Indonesia, Korea, Republic of, Lao People's Democratic Republic, the Maldives, Malaysia, Mongolia, Myanmar, Nepal, Pakistan, the Philippines, Singapore, Sri Lanka, Thailand, Viet Nam

Central and Eastern Europe: Albania, Belarus, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Republic of, Poland, Romania, Russian Federation, Slovakia, Slovenia, the Ukraine

[8] Average for the period. Based on data for the selected countries.

[9] Average for 1991-2000

[10] World Investment Report 1998

[11] The financial crisis in Asia and Foreign Direct Investment: An assessment, United Nations, Geneva, 1998.

[12] The higher the score the better

[13] Average of the total score for 1993-2000

[14] Calculated as an average for the period 1990-2000. Based on FDI data from Eurostat and UNCTAD

[15] FDI data as average for the period 1993-1998; exports data are average for the period 1997-1998; values in US$ million and shares as percentage

[16] The data are from UNCTAD

[17] Source: World Investment Report, UNCTAD, 2001

[18] Idem

[19] Economic Commission for Latin America and the Caribbean

[20] World Investment Report, UNCTAD, New York and Geneva, 1999

[21] Countries such as Bolivia, Ecuador and Peru are rich in natural resources

[22] Sikorski, D., Th. Menkhoff, Internationalisation and rationalisation of firms: The Asian Context, Singapore Management Review, 22(1), pp. 1-17, First Half, 2000

[23] Export propensity is measured as a percentage of total sales

[24] World Investment Report, UNCTAD, 1998

[25] Stone F.S., Jeon B.M., *Gravity-model specification for foreign direct investment: A case of the Asia-Pacific economies,* The Journal of Business and Economic Studies, Fairfield, Vol. 5, Issue 1, 1999

Chapter 2

Dynamics of FDI in Central and Eastern Europe

1. INTRODUCTION

The dynamics and the nature of the Foreign Direct Investment (FDI) in Central and Eastern Europe (CEE) are analysed in this chapter. Three phases of the economic co-operation between Western and CEE companies are distinguished. These are:

- A phase when traditional trade dominated (before 1970s);
- A phase of emerging industrial co-operation when the first equity investments were made (1970s and 1980s);
- A phase of accelerated foreign investments, in a variety of forms (1990s).

Major trends are identified for the period 1990-2000 (section 3) in trade and FDI. Countries from the region are compared with each other on a number of FDI indicators. The attractiveness of different sectors in different countries is identified and the major Western investors are ranked. The impact of FDI on local economies is reviewed in 3.4 in terms of economic growth and competitiveness, labour market and various spin-offs.

2. TRADE AND PILOT INVESTMENTS

At the beginning of the 1960s East-West trade increased rapidly and grew approximately 300 percent by 1979. Until about 1989 it grew continuously but at a lower rate. Western countries were exporting machinery, transport equipment and manufactured goods to the countries of

Central and Eastern Europe (CMEA[1] or Comecon countries at that time). Respectively, CMEA countries were supplying the West with raw materials, minerals and fuels, food, beverages, tobacco and some engineering products. Almost all commercial transactions were carried out by state trading companies, specially created and authorised for the purpose. Soon they had become huge in size and very influential. In the 1980s most of the Western countries signed bilateral trade agreements with the CMEA countries for periods ranging from three to six years. These were meant to secure stable trading relationships for a certain period and ensure the guarantee of the state. Bilateral agreements soon became broader in scope, involving not only trade issues, but also other issues such as industrial, scientific and technological co-operation. It was a period of break-through behind the iron curtain, caused by the growing need for internationalisation in the West and the attempts of the East European governments to find sources of economic growth and technological development.

The preferences for different forms of co-operation varied among CMEA countries. Czechoslovakia had co-production with the West as its first priority and licensing as its second. Poland preferred licensing and delivery of equipment and turnkey projects. Hungary was clearly interested in joint ventures but held little regard for co-production. Bulgaria never showed a clear preferential policy towards these forms of investment and equally inactively pursued co-production, joint ventures and delivery of equipment.

The new trends between the years 1970 and 1989 were that industrial co-operation became more intensive and the forms of co-operation more diversified. One of the reasons was the planned economies' new policies, which dealt with opening up to foreign investments. Hungary and Poland played a leading role in this process followed by Bulgaria and Czechoslovakia, and were followed later on by the Soviet Union (in fact the former Yugoslavia was the first socialist country of the region to permit joint ventures on its territory in 1967). In contrast to the political and social rules of management, companies in these countries were given more relaxed regulations for entering into direct business contracts with Western companies. These policies gained speed because of the decline of trade at the time and desperately needed hard currency. Consequently, an increasing number of special laws and regulations were introduced, aimed at stimulating foreign direct investments (FDI). This created investment conditions for Western companies that were, at that time, quite favourable. The result was an increasing number of joint venture contracts from 1982. In 1987 such contracts represented 19.3 percent of all commercial agreements regarding partnerships between CMEA and Western countries. In 1989 joint ventures ranked second among all forms of industrial East-West co-operation (see Table 2-1).

Table 2-1. Ranking the main forms of East-West co-operation

Forms of co-operation *	1973	1976	1984	1986	1988
Co-production	1	1	1	1	1
Licensing	2	3	4	4	4
Joint Ventures **	3	4	3	2	2
Delivery	4	2	2	3	3

Source: statistical data from ECE Trade Reports and East-West Investment News by years.
Notes: * Only the years where changes occurred are shown.
** Including joint ventures located both in West and East.

CMEA countries again exhibited differences. Romania enacted legislation in 1971 allowing East-West joint ventures within its territory. Unfortunately the regime of Ceauscescu has halted the realisation of this legislation. As a result, Romania was excluded from foreign investors' lists until the changes in the 1990s.

In 1972 Hungary permitted East-West joint ventures with a maximum 49 percent foreign participation, a case-by-case incentive structure and a 40 percent basic tax on profit. Up until 1989 Hungary had amended its laws and regulations concerning foreign investment more than ten times in order to accommodate the wishes of foreign partners and therefore stimulate the country's economy. This political behaviour strongly influenced the number of joint ventures that subsequently grew and reached more than 600 by 1989.[2] Major legal changes in 1988 abolished the limit on equity participation of foreign partners and in fact allowed for fully owned foreign companies to operate in Hungary. In addition, it broadened the scope of participation and put all companies in the country in the same economic and business conditions. As a result, the number of joint ventures in 1988 alone had doubled.

Bulgaria introduced a special decree in 1980 that allowed for 99 percent foreign participation in joint ventures with the limitation that there should be at least one local partner. The law established the profit tax rate at 20 percent and opened the possibility for case-by-case taxation incentives. The law amendment in 1989 allowed for 100 percent foreign owned companies. Although the latter changes stimulated the process, the number of joint ventures was only about 40 by 1989.

Three other countries (e.g. Czechoslovakia, Poland, the Soviet Union) either enacted special legislation or issued a policy statement permitting joint ventures with foreign participation in the mid-1980s.

Czechoslovakia started to consider foreign joint ventures on a case-by-case basis as of 1985 but only 16 joint ventures were in operation by 1989. However, the special Act on enterprises with foreign property participation that became effective in 1989 accelerated the process (within the first two months of 1989, eight more joint ventures were registered).

Poland allowed for East-West joint ventures with up to 49 percent foreign participation in 1986. The basic profit tax was 50 percent but with tax waving in the first two years and tax incentives for products made for export. Full foreign ownership was permitted in 1989 where tax incentives were strengthened and profit tax lowered. Poland has enjoyed a rapid growth of joint ventures, there was more than 400 by 1989 and thus followed the success of Hungary in the number of foreign companies present.

Although the number of East-West joint ventures in the six CMEA countries that actually allowed foreign participation was relatively high, taking the economic conditions at that time into account, the total capital invested was low. Total capitalisation amounted to roughly US$ 2.5 billion by 1989. On average joint ventures back then were small with no more than US$ 1 million of initial capital being invested.

Industries, services and to a much lesser extent R&D, training, engineering and consultancy activities have all attracted foreign capital. Most of the joint ventures started with trade, engineering and technical services and then moved towards small-scale production. As for the field of foreign investment, countries do show some differences. Hungarian joint ventures covered a very broad range of economic activities. Manufacturing, services and finance had almost equal shares, close to 30 percent each. The majority of joint ventures in Bulgaria were in engineering. The traditionally well developed Czech machine building and machine tools sectors attracted a quarter of all joint ventures in that country. Czech joint ventures were mainly used for the production of spare parts for Western companies. Joint ventures in socialist Central Europe were predominately for production and not so much for R&D or marketing.

Germany[3] was the biggest investor in the 1980s, closely followed by Austria, Italy, the UK and the USA. The primary motivation of the Western partners was to enlarge the scope of their market and to encompass new markets and marketing channels.[4] Low labour costs and a supply of cheaper raw materials were not that much of a driving force. In reality, though, Western partners benefited more from the lower costs and were unable to realise their full market ambitions.

In the 1980s the expansion of the FDI process was limited due to the following reasons:

- Centrally planned economies were still not yet able to match one of the most important objectives of cross-border alliances, that of market expansion.
- The process of negotiating, establishing and operating East-West joint ventures was very much administered and influenced by the state. The average time needed to set up a joint venture was about 5 years[5].
- The centrally planned economy was restricting the operations of the joint ventures. Joint ventures were facing severe problems in

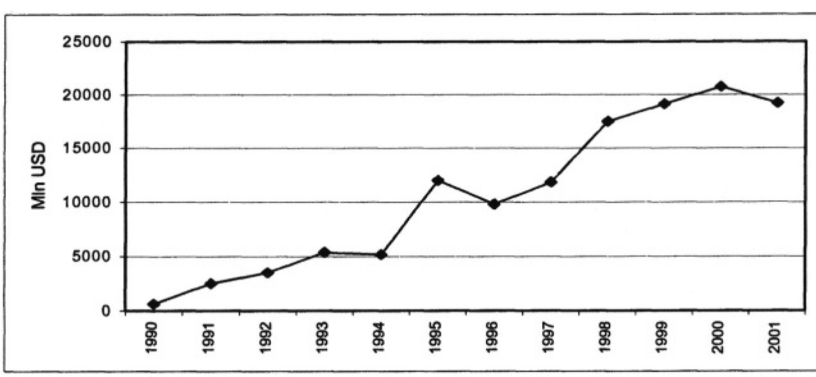
managing their finances, establishing real pricing, negotiating with local suppliers and most of all predicting market and customers' behaviour.

– An uncertain legal basis and political behaviour were causing hesitation amongst Western companies.

Between 1989 and 1991, when centrally planned economies in Europe took the road towards a free market and democracy, the total number of foreign enterprises (FIEs[6]) grew from 14 700 in January 1991 to 31 000 a year later. By 1994, the total number of FIEs was estimated to be approximately 100 000, some 30 percent more than a year earlier. The role of the joint venture as a form of foreign investment that had dominated in the 1980s made way for other forms of equity participation. A period of accelerated growth in FDI to Central and Eastern Europe had begun.

3. TEN YEARS OF EXPANSION

Since the transformation process that began in Central and Eastern Europe (CEE) between 1989 and 1990, the markets of former socialist countries were added to the list of emerging markets in the world. Foreign direct investments took immediate advantage of the situation and as a result, the foreign direct investment flows into the region in the year 2000 was about 40 times than that of 1990 (see Figure 2-1).



Source: WIIW – WIFO database

Figure 2-1. **Dynamics of FDI inflow to Central and Eastern Europe for the last decade of the 20th century**

Now, more than ten years after the opening of the former centrally planned economies, foreign direct investments have built up a history that has its own dynamics and characteristics. Trends show different performance levels between the countries in the region. To foreign investors, the

attractiveness of the sectors in East European economies shows several patterns. In the large countries - investors are holding their position quite persistently.

3.1 Trade between CEFTA[7] countries and the European Union

Central and Eastern European countries (CEECs) lost their traditional markets and trade partners within CMEA[8] in the 1990s and they had to search for new markets and trade opportunities. Their main trading partner has become the European Union (EU). The switch of the CEECs in trade orientation has faced high competition on the EU market. Exports from Central and Eastern European countries to the EU have had to compete with EU products as well as with products of competitors from the CEE region.

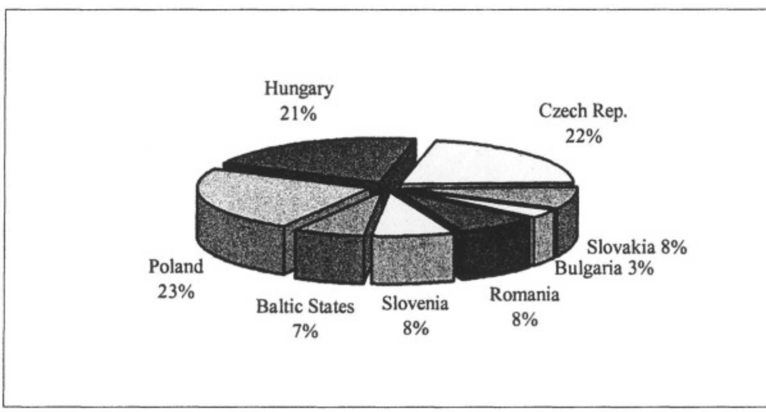


Figure 2-2. **CEFTA countries export share to the EU (average for 1991-2000)**

In the period 1991-2000, trade between the CEFTA countries and the European Union showed a continuous surplus in favour of the European Union. Despite a steady growth in total trade and an increasing share of imports from and exports to the European Union, the balance of trade has shifted towards a growing deficit for CEFTA countries (see Figure 2-3). The trade deficit became a structural problem after peaking both in 1993 and 1996. In 1993 imports grew by 75 percent while exports increased by only 53 percent compared to 1992. This year alone gave rise to a trade-deficit of approximately ECU[9] 5 billion. In 1996 the deficit grew even further when imports from EU countries increased by 20 percent and exports lagged behind growing only six percent in comparison to 1995. The trade deficit reached approximately € 8 billion. Although, since 1997, there has been a

tendency to balance exports and imports, CEFTA countries still maintain an export/import-ratio of ¾ (for every unit of import, 0.75 units of export realised). The trade deficit reached € 22 billion in 1999. In order to keep the trade deficit at the same level, exports should grow by at least 34 percent more than the imports.

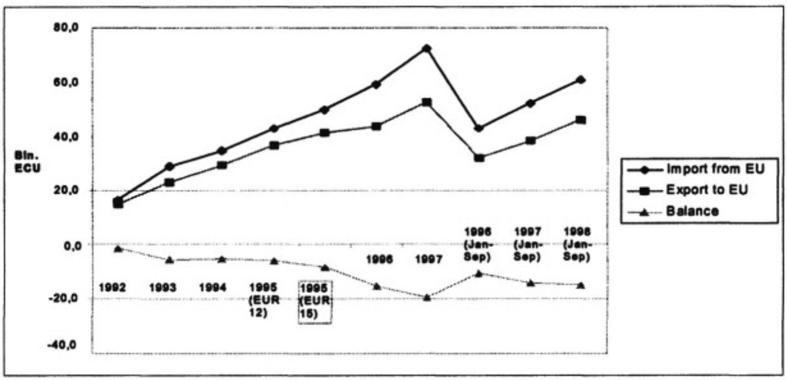
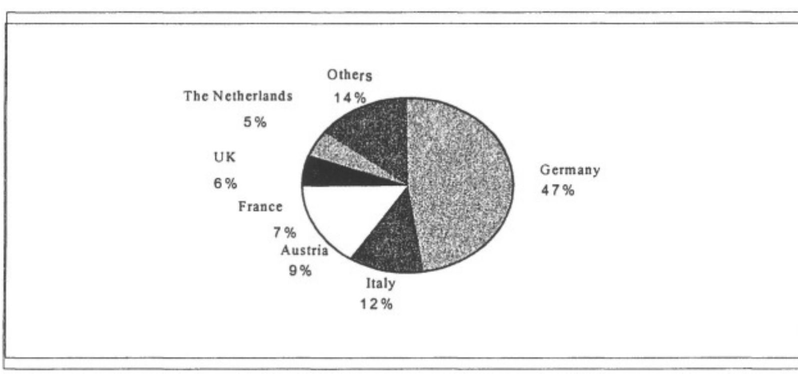


Figure 2-3. CEFTA trade with the EU (1992-1998)[10]

The main trading partners of the CEE countries are Germany, Italy and Austria, followed by France, the United Kingdom and the Netherlands.



Note: percent = Share of this country in the total of the European Union (15 countries). Data received from DGII of the European Commission.

Figure 2-4. CEE main export partners

Between 1997 and 1998 the total exports of CEE to the European Union increased by more than ECU 8 billion. In this period the growth of exports to each of the European Union trading partners was positive and resulted in a growth in total exports of 17 percent compared to previous years. The growth of CEE exports to Germany and France increased from 18 percent

(1997) to 22 percent (1998) and from 5 percent (1997) to 28 percent (1998) respectively. The CEE growth in exports to other countries in the European Union, however, decreased between 1997 and 1998.

In 1998 the main trading partners of the CEE countries in imports were the same countries as those in exports. Germany held a share of 41 percent followed by Italy with 12 percent, Austria and France each with 8 percent and the UK and the Netherlands with 5 percent.

The most important CEE exports to the EU were in the following sectors: machinery and electrical equipment, textiles, base metals, transport equipment, chemical products, mineral products, wood, agricultural products, plastic products. The largest share in exports (25 percent in 1998) was taken by machinery and electrical equipment. The textile sector had the second largest share followed by base metals representing 14 percent and 13 percent of the total CEE exports to the EU respectively. The export of textile and base metal products remained stable in 1997 and 1998. The export of transport equipment grew from 9 percent in 1997 to 12 percent in 1998. Miscellaneous manufacturing exports remained stable with a share of 6 percent and the export of mineral products dropped from 6 percent in 1997 to a share of 4 percent of the total exports from CEE countries to the EU in 1998.

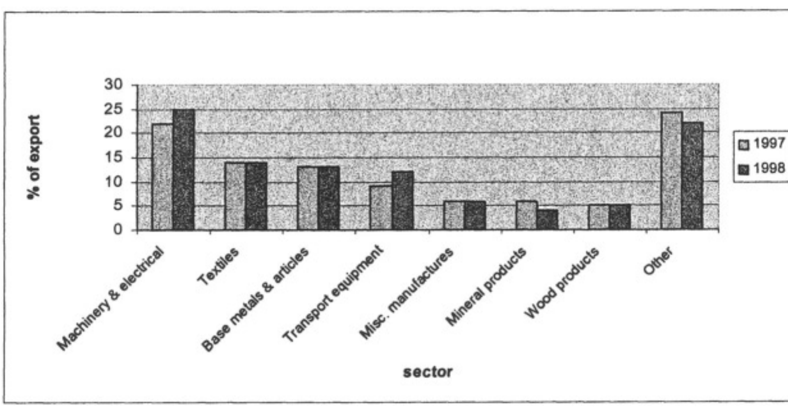


Figure 2-5. **CEE main export sectors to the EU** [11]

CEE imports from the EU are similar in structure to CEE export to the EU. Imports are composed as follows: the machinery and electrical equipment sector ranked first with a share of 32 percent of the total CEE imports from the EU in 1998. The transport equipment sector ranked second with an increasing share of 13 percent. Chemical products and textiles shared the third place with a share of 9 percent.

Table 2-2. Sector structure of the CEFTA export (in %)

Country / Sector	Poland	Hungary	Czech Rep.	Slovakia	Bulgaria	Romania	Slovenia
Agriculture	7	7	N/A.	N/A.	10	3	N/A.
Base metals & articles	14	8	14	18	27	17	12
Chemical products	N/A.	3	N/A.	3	7	2	N/A.
Machinery& electrical	16	50	25	18	8	9	22
Textile	14	9	7	10	26	38	12
Transport equipment	10	6	18	30	N/A	N/A	19
Total	61	83	64	69	78	69	65

In 1998 the export sectors of machinery and electrical equipment and transport equipment experienced the strongest growth in the Czech Republic, Slovakia and Hungary. These two sectors accounted for 50 percent of Hungary's total exports to the EU in 1998. For the Czech Republic, Slovakia and Slovenia the share of machinery and electrical equipment and transport equipment together exceeded 40 percent of their total exports to the EU.

3.2 FDI in figures

Central and Eastern Europe[12] attracted about US$ 615 million[13] in FDI in 1990. Unprecedented growth was observed up until 1995 when the total FDI inflows for the region reached US$ 12 billion, thus increasing 20 times. From 1995 to 2000 the increase was only 1.7 times greater with signs of saturation appearing somewhere in 1998.

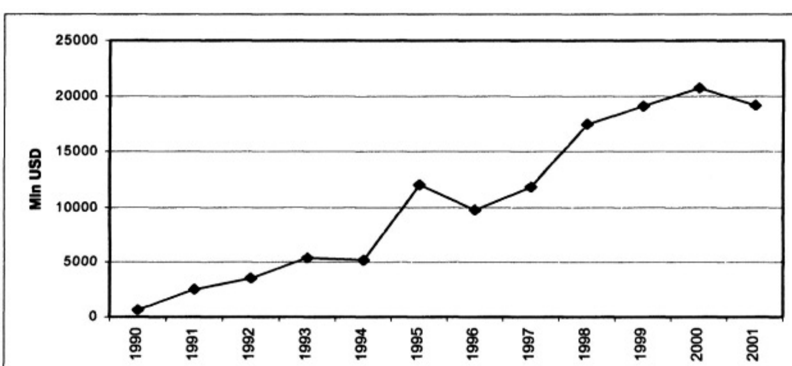


Figure 2-6. FDI to Central and Eastern Europe in 1990-2000

To summarise, the FDI inflows into Central and Eastern Europe have increased about 40 times in the ten-year period of 1990-2000, a growth that is unique in the history of FDI in the world (see Figure 2-6).

In the following sections trends and patterns of the FDI process in this ten-year period will be considered more closely. The following analysis is based on international and national statistical data. Although FDI is a subject that has attracted substantial interest from many analysts, statistics on the subject remain scattered, incomplete and very general. For the purpose of this book, four types of sources namely UNCTAD[14], EBRD[15], WIIW – WIFO database[16], and statistics provided by national Foreign Investment Agencies (FIAs), have been compared. The IMF, the National Banks and the National Statistics Institutes are often the primary sources for some of the data collected by these institutions. Contrary to the scarcity and insufficiency of FDI data for the years prior to 1990, the years after 1990 are better covered by the databases of the above-mentioned institutions. The sufficient level of comparability of data for the period 1990-2000 allows the use of different data sources, mainly UNCTAD, WIIW and EBRD. The data provided by the FIAs sometimes differs from international figures although the level of disaggregation is much higher than that of the international data providers. The United Nations Economic Commission for Europe has published quarterly East-West Investment News between 1989 and 1996 where specific FDI issues were covered. Presently, no publication provides as much detailed information as the East-West Investment News. The international data of today are primarily macro figures that can be used to outline general FDI trends in CEE while allowing reliable comparisons within the region and with the other regions of the world. However, it hardly offers information that may be of direct interest to the business community.

3.3 Countries - front runners in CEE

The trend for FDI inflows to Central and Eastern European countries experienced a steady and continued growth in the last decade of the 20th century among all countries in the region. The best performing countries in absolute terms were Poland, Hungary and the Czech Republic[17] (see Figure 2-7).

The data for 1990-2000 show a positive change in the amount of FDI inflows into all CEE countries every single year with the exception of 1996.[18] In spite of a decline of 18.6 percent in 1996 compared to 1995, the level of FDI inflows in 1997 recovered and almost reached the level of inflows in 1995. The trend of substantial growth of FDI in the region was maintained until 1998 when it slowly began to saturate.

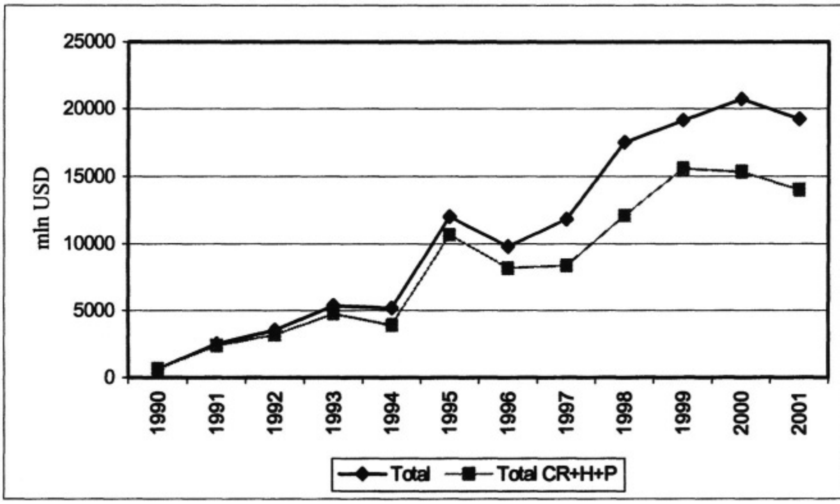


Figure 2-7. **FDI flows to the region and to the three countries, front-runners**

The average annual growth in FDI shows that four countries are leading the rest of the field and these are Lithuania with an average annual increase of 57.5 percent, Poland with 47 percent, Romania with 43.4 percent and the Slovak Republic with 43.2 percent (see Figure 2-8). The figures are partly misleading since most of the countries had to start entirely from scratch. Hungary shows the lowest average annual growth, although when judged by all other indicators it has always been among the best performers in terms of attracting FDI. This country had a quite different starting position. In 1990 Hungary accounted for two thirds of the total FDI for the region. Investment inflows have grown approximately ten times (against 40 times for the region as total) within the period 1990-2000 reaching a peak in 1995 and experiencing a decrease afterwards. Nevertheless, Hungary ranks in third position after Poland and the Czech Republic, measured by the total FDI attracted in the ten-year period. Although the countries, taken as a whole, show a trend of increasing FDI inflows, every country follows its own development with ups and downs in different years. This is due to many factors influencing FDI that reflect country's specific economic, political and historical characteristics.

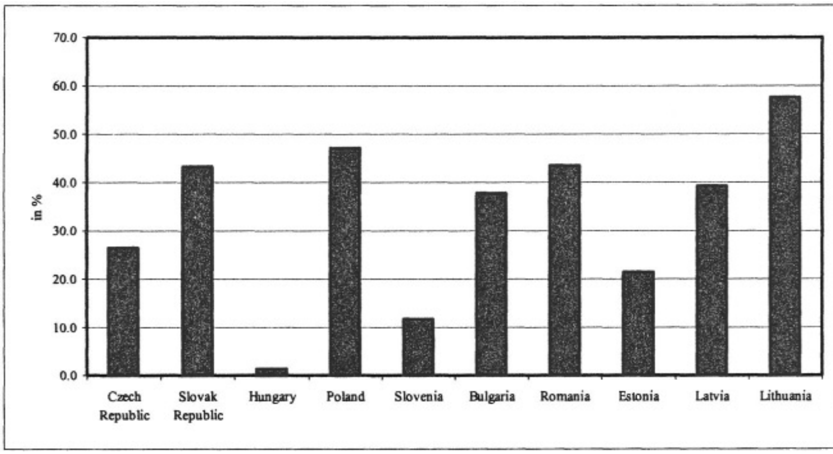


Figure 2-8. Average annual growth rate in FDI inflows for 1990-2000 (geometric mean)

A large part of the total FDI in the region accumulated in the period 1990-2000 was distributed to only a few countries. The largest recipients, with a total share of 77.6 percent[19], were the Czech Republic, Poland and Hungary. The total cumulative inflow to the region for the years 1993-2000[20] was US$ 101 497 million, of which US$ 39 260 million went to Poland, to Hungary - US$ 18 093 million and US$ 21 450 million to the Czech Republic (see Figure 2-9). There were years (e.g. 1994, 1995, 1996) when the three countries were receiving around 85 percent of the total foreign capital invested into the region.

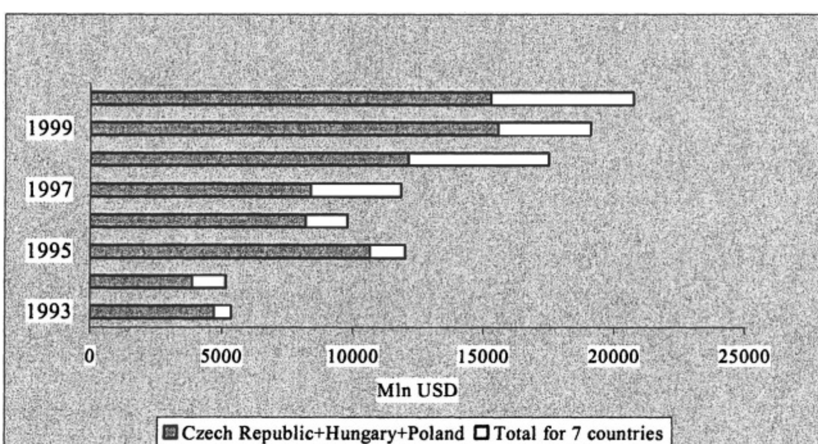


Figure 2-9. Share of the three front running countries in the total FDI to CEE

The Czech Republic, Hungary and Estonia appeared to be at the forefront in terms of FDI inflows per capita (see Figure 2-10). Poland and Latvia held the fourth position, very closely followed by Slovenia, Slovakia and Lithuania. Bulgaria and Romania were last with a cumulative inflow per capita of US$ 403 and US$ 290 respectively (1990-2000).

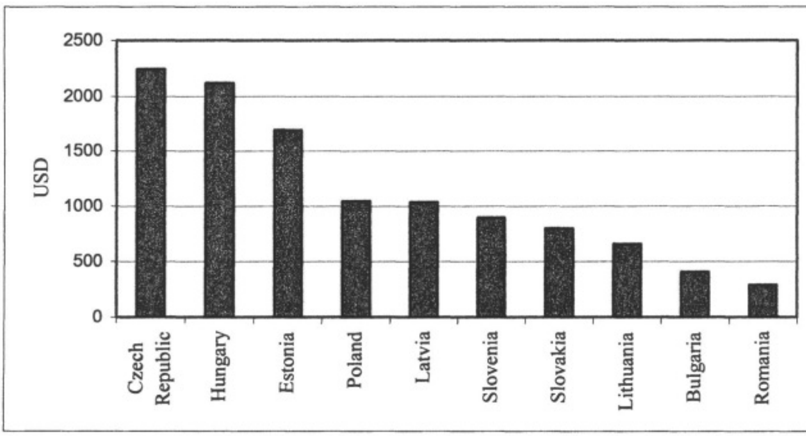


Figure 2-10. **FDI (cumulative inflow) per capita for the period 1990-2000**[21]

The FDI/GDP ratio for the region has increased over time (see Figure 2-11). It reflects the fact that the growth of GDP is much lower than that of FDI. Judged on the basis of the average value of the FDI/GDP indicator for 1990-2000, the leading countries were somewhat different from the leaders in absolute amounts of FDI: the Czech Republic, Hungary and Poland. The first and the second place were held by Estonia and Latvia with 7.14 and 5.87 percent respectively.

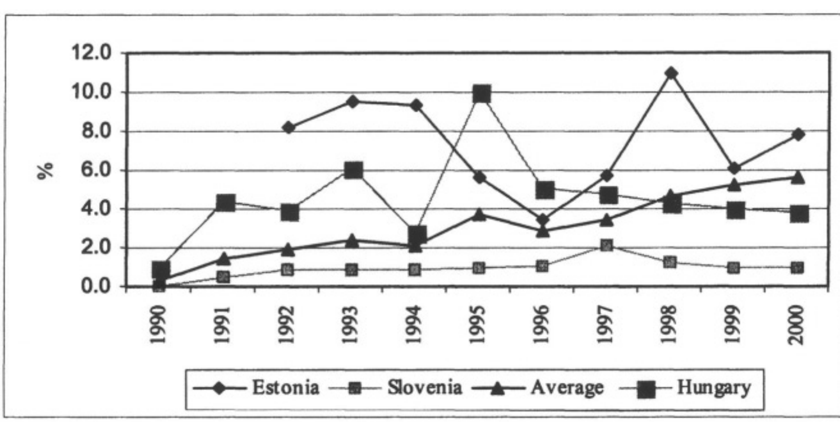


Figure 2-11. **FDI inflow as a percentage of the GDP**

Classified in accordance with the FDI/GDP ratio, the Czech Republic was third (4.74%) and Hungary fourth (4.64%). Hungary was holding the first position in the years up to 1995. Poland maintained an average value of this indicator close to 3 percent. The lowest value of approximately 1 percent was held by Slovenia.

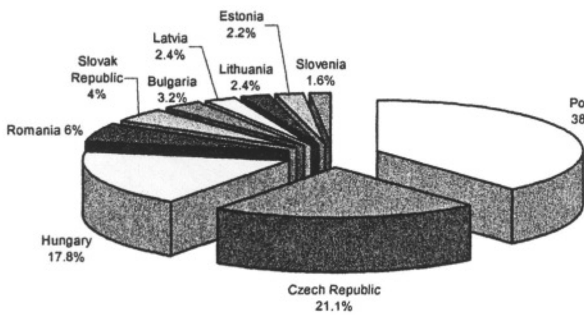


Figure 2-12.[22] **Distribution of FDI by countries of the CEE (cumulative 1993-2000)**

The ten-year period witnessed growing interest in Central and Eastern European countries as investment destinations. The FDI flow has been selective and the Czech Republic, Hungary and Poland were clearly preferred (see Figure 2-12). However, expressed in relative terms, Estonia and Latvia also made substantial progress.

3.3.1 Sectoral attractiveness

The general trends in the distribution of FDI by industrial sectors are very difficult to describe due to a lack of detailed and comparable data. In addition, the available information does not always reflect the reality or is misleading. Often single projects dominate the sectoral breakdown of foreign investments for a particular year or there is a significant amount of FDI identified as unallocated. Despite these obstacles, certain trends can be observed, namely the importance of the secondary and tertiary sectors, the minor role of the primary sector and the shift from manufacturing to services.

Table 2-3 reflects the situation by the end of the last decade of the 20th century in the FDI inward stocks classified by sectors. The calculations are based on UNCTAD data on sectoral distribution of FDI inward stocks.[23] The table shows the number of countries that have a significant share of the specific industry in the total FDI inward stocks. The importance of particular

industries is given per country. The evaluation in the last column is constructed in such a way that the first category accounts for the highest impact, the second category – for the medium one and the last category has the least weight.[24] The results of this analysis indicate that the primary sector has not been of significant importance to foreign investors.

Table 2-3. Importance of sectors for FDI inflows

	Category of importance			Score
	Most important	**Very important**	**Important**	
Basic level	More than 50 percent	40-50 percent	30-40 percent	
Detailed level	More than 20 percent	10-20 percent	5-10 percent	
PRIMARY SECTOR	**1**	**0**	**0**	**3**
Agriculture, hunting, forestry & fishing	0	0	0	0
Mining, quarrying & petroleum	1	0	0	3
SECONDARY SECTOR	**1**	**8**	**4**	**23**
Food, beverages & tobacco	3	3	4	19
Wood, paper, publishing & printing	0	1	2	4
Coke & petroleum products	0	1	0	2
Chemicals & chemical products	1	0	4	7
Non-metal products	0	1	2	4
Machinery & equipment	1	3	1	10
Motor vehicles and other transport equipment	0	1	2	4
TERTIARY SECTOR	**9**	**4**	**1**	**36**
Electricity & water distribution	1	1	1	6
Construction	0	1	2	4
Wholesale trade & distributive trade	4	8	0	28
Transport, storage & telecommunications	4	0	6	18
Finance (& banking & insurance)	3	5	2	21
Real estate, rental activities & business	0	2	5	9
Other and unspecified tertiary	2	0	0	6

A large majority of FDI has been received by the secondary and tertiary sectors. Nine out of fifteen CEE countries[25] reported to have more than 50 percent and four out of eighteen between 40 and 50 percent of the country's FDI inward stock distributed into the tertiary sector.[26] The tertiary sector has gained more interest due to latest large privatisations of public utilities. The most attractive industries for FDI in the tertiary sector are wholesale trade

and distribution, finance, transport, the telecommunications industry, electricity and water distribution.

The distribution within the secondary sector does not show such significant common trends as the tertiary sector. The only obvious development is that food industry is receiving relatively much FDI. One should take into account that the results of this analysis may not be completely accurate due to missing detailed data for some sectors in some countries such as Slovakia and Romania. Nonetheless, the suggested trends are generally valid for the whole region.

According to the World Investment Report 2000, the share of FDI directed to services increased from 50 percent in 1998 to approximately 56 percent in 1999. The tendency for greater investment into the tertiary (service) sector rather than into manufacturing represents a clear shift in FDI inflows over the last few years (see Figure 2-13). This trend, observed in the Czech Republic as well as in Poland, was not, however, significant in Slovakia and Slovenia. The (limited) scale of privatisation and the limited overall progress made in attracting FDI may have played a role in this case. While some countries, having nearly completed the privatisation of the manufacturing industry and having started the privatisation of services, other countries have not yet progressed that far. As the privatisation of the service sectors has not yet been completed, further progress in attracting FDI into the tertiary sector can be expected in the coming years.

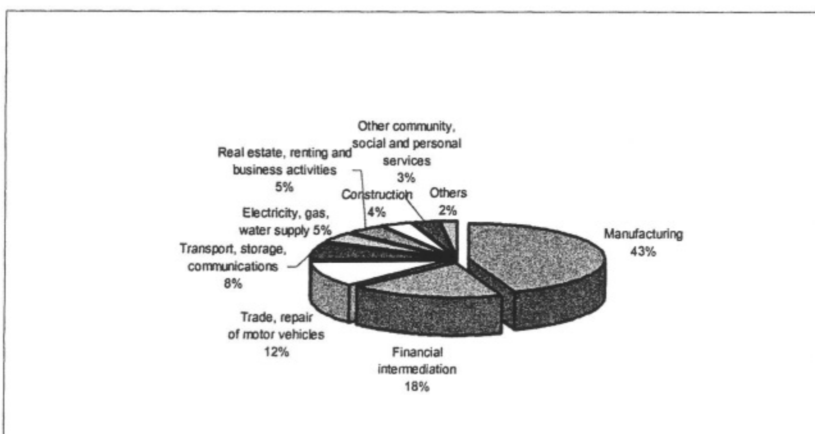


Figure 2-13. **Sectoral distribution of FDI**

Although there are certain common trends for the region as a whole, each country has followed its own pattern as far as the sectoral distribution of FDI is concerned. The major part of FDI in manufacturing industries in the Czech Republic, Hungary and Poland is received by the food, beverage and tobacco

industries and by transport equipment sector. In Hungary, the most attractive manufacturing sectors have been machinery and electrical goods. Minerals and chemical sectors have received a sizeable share of the total FDI in this country. Textiles, leather, wood, paper and rubber attracted modest amounts of foreign investment. In the tertiary sector, Hungary received substantial FDI inflows in the electricity, gas and water supply and in the wholesale trade.[27] The Polish sectors that attracted the majority of FDI have been financial intermediaries, followed by the food industry and transport and equipment.[28] The Czech Republic has attracted FDI mainly in its transport and automobile industries, communication, construction and financial activities.[29] While in general terms the investment pattern by sectors corresponds to the market size, there are exceptions to this rule. The Czech Republic has attracted significantly higher level of FDI in transport equipment. The pulp industry in Poland has received FDI inflows that are disproportionate for the size of the market. At the same time, investment in machinery and equipment manufacturing is relatively low.[30]

In terms of the shift of FDI from the secondary sector to the tertiary, a clear distinction can be observed between some countries from Central Europe (the Czech Republic, Hungary) and some from Southeast Europe (Bulgaria and Romania) and the Baltic states. In the first group of countries the shift of FDI from manufacturing to services took place in the middle of the decade (1995-1996). At that time foreign investors were still concentrating their investments into the secondary sector in the other countries. The main reason for this delay is the slower pace of privatisation in the service sector, primarily in public utilities. The share of the secondary sector in the total FDI stayed at 60 percent up till 1998. FDI distribution between the secondary and tertiary sectors reached a 50/50 level after 1999. Slovakia had the same distribution of FDI between the secondary and tertiary sectors for a number of years

Even though Poland, the Czech Republic and Hungary have similar characteristics in terms of economic development, there are differences in the breakdown of industrial FDI received. These differences are due to different methods of privatisation, different basic characteristics of the countries, such as the size of the market, economic importance and technological advancement of the sectors. Focused FDI policies have also played an important role in attracting investments in specific sectors.

3.3.2 Major Western investors

The largest investors in Central and Eastern Europe (see Table 2-4) are Germany, the USA, Austria and the Netherlands, as far as CEE countries of the central and southern parts of Europe are concerned. Sweden, Finland and Denmark are the primary investors in the Baltic states.

Table 2-4. Importance of the country of origin

	Number of countries (out of 16)				
	Most important	Very important	Important	Not important	Aggregate level
Germany	5	4	4	3	27
United States	2	7	3	5	20
Austria	2	4	1	9	15
Netherlands	1	3	3	9	12
Russian Federation	3	0	2	11	11
United Kingdom	0	1	6	9	8
France	0	2	2	12	6
Cyprus	1	0	2	13	5
Sweden	1	0	1	15	4
Japan	1	0	0	15	3

Source: UNCTAD, own calculations

The role of a country-investor is defined as "most important" in Table 2-4 if its share in the total FDI stock in the host economy is more than 20 percent. As "very important" are defined investors with a share between 10 and 20 percent. "Important" are investors with a 5-10 percent share and "unimportant" are those with a share below 5 percent.[31] The classification changes slightly each year, but the trend is clear (see Table 2-5). Germany has a clear predominance in terms of volume of FDI invested in CEE.

Table 2-5. Largest investors in CEEC based on FDI stock (1992-2002, US$ million)[32]

Bulgaria	Czech Republic	Hungary	Estonia	Latvia
Germany	Germany	Germany	Sweden	Sweden
Greece	Netherlands	Netherlands	Finland	Germany
Italy	Austria	Austria	USA	Denmark
Belgium	France	USA	Netherlands	USA
Austria	USA	Norway	Norway	
Lithuania	**Romania**	**Poland**	**Slovakia**	**Slovenia**
Sweden	Netherlands	France	Germany	Austria
Denmark	Germany	USA	Netherlands	France
Estonia	USA	Germany	Austria	Germany
Germany	France	Netherlands	USA	Italy
USA	Austria	UK	UK	Czech Republic

According to Hunya (2000) the amount of FDI in CEE countries is positively related to the size of the home country and negatively related to

the distance of the host country. This explains the dominant position of Germany, as it has both the size and the proximity. This is enforced by additional factors, such as historical and cultural linkages.

The importance of neighbouring countries as investors is clear. This is evident from the case of Germany and Austria in the Czech Republic, Hungary, Slovenia and Slovakia and the Scandinavian countries in the Baltic states. At the same time the Netherlands is among the leading investors in Romania, the Czech Republic and Hungary without being large in size or bordering with these countries. The USA is among the biggest investors in the region and although it is large in size, it is quite distant. In addition to distance and size of the country-investor, many other investment determinants contribute to the final result that, for example, makes the USA and Germany the biggest investors in the world.

3.4 The impact of FDI on local economies

The effects of FDI are traditionally discussed in the theory of international trade that sees FDI and trade as substitutes and their impact on the local economies as similar to each other. Since the 1950s when this view emerged, developments in both trade and FDI have provided different dimensions to the effects of FDI on the economies of the host countries. In addition to the tangible effects, that can be measured more or less easily, a number of intangible impacts have been encountered. The tangible effects include: economic growth, increased level of trade, increased employment, contribution to the capital formation and better wages and productivity. Intangible are effects such as technology transfer, transfer of know-how and skills, corporate restructuring, improved management practices and better work attitudes. Foreign companies may provide human resource training and technical assistance to customers. Through a spin-off mechanism, FDI often improves management and marketing skills as well as to the development of technology and intellectual property in the host country. By upgrading quality, increasing labour productivity and using proprietary global supply networks, FDI can encourage competition in the local market. As a result, the crowding-out of domestic companies may cause short-term job losses as well as bankruptcy waves among local producers. However, FDI is likely to be beneficial for the economy in the long run, and thus outweigh the initial negative impact. In addition, FDI, acting as a supplement to domestic savings and increasing the total level of capital investment, has a positive impact on economic growth.

Many researchers have struggled with the question to what extent and under which conditions FDI has a positive effect on local economies and societies. Blomstrom and Kokko (2001)[33] offer quite an extensive review of different views and theories on the effects of FDI. These authors argue that

the positive effects of FDI are not automatic and that they depend on the country's characteristics and policies. The effects may also be industry and technology specific.

FDI impacts can also be linked to the form of investment. As suggested by the World Investment Report (2000), the effects of a greenfield investment are much more positive than the impact of take-overs. According to Geenhuizen and Nijkamp (1998) the type of investment is even more important to the recipient country than the amount of investment itself.

Although the effects of FDI have been studied extensively, there are some controversies in the results of the research and little empirical evidence. This also concerns the impact of FDI in Central and Eastern Europe.

3.4.1 Economic growth and competitiveness

Campos and Kinoshita (2001)[34] have attempted to assess empirically the impact of FDI on economic growth of CEE.[35] Their findings support the hypothesis that "FDI has an impact on economic growth that is positive, statistically significant, direct, unconditional, causal and robust."[36] Furthermore, the researchers show that "FDI is a crucially important explanatory variable for growth in transition, maybe more important than education and liberalisation".[37]

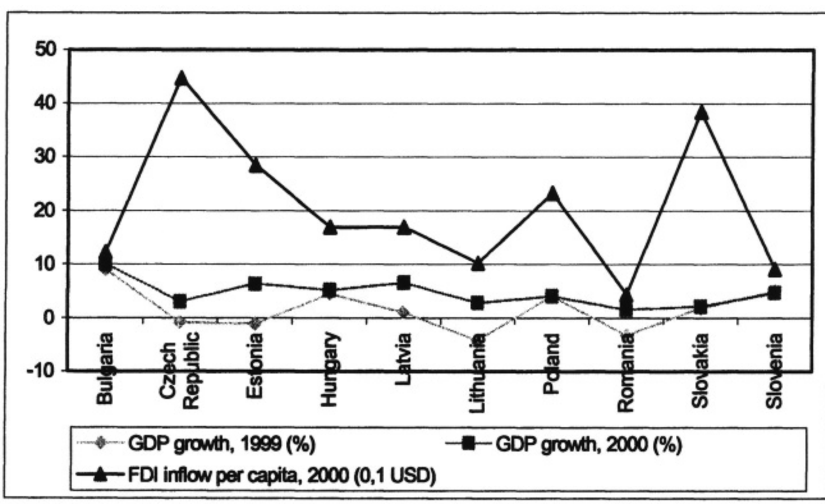


Figure 2-14. GDP growth and FDI per capita

The data however do not show a simple relationship between GDP growth and FDI inflows into CEE (see Figure 2-14). One reason for this may

be the long-term nature of the effect of FDI on economic growth; there seems to exist a real time gap between FDI inflow and its effect on the recipient economy. In addition, factors other than FDI may affect economic growth.

One of the indicators used to measure the effects of FDI on economic growth is the FDI inward stock[38] as a percentage of the host country's GDP (see Table 2-6). The growth of this indicator for the period 1990-2000 is impressive although the starting level is negligible. Most important is the fact that in a number of CEE countries the FDI share of GDP is above world average, as well as above EU average. In many cases this figure is above the value for a number of EU countries of a similar size.

Table 2-6. **FDI inward stocks as percentage of GDP[39]**

	1990	1995	2000
World	9	10	20
Western Europe	11	13	30
EU	11	13	30
Latin America	10	12	31
Asia	15	17	32
CEE	2	5	19
Bulgaria	1	3	26
Czech Republic	4	14	43
Estonia		14	53
Hungary	2	27	43
Latvia		13	29
Lithuania		6	21
Poland	0	6	21
Romania	2	3	18
Slovak Republic	1	4	24
Slovenia	4	9	15
Austria	6	7	16
Germany	7	8	24
Greece	9	11	11
Ireland	7	14	68
Netherlands	23	28	66
Portugal	15	17	27

The contribution of the Hungarian foreign investment enterprises to the national product in 1995 was at 17 percent the highest of the region. That of the Polish and Estonian companies was 11 and 7 percent respectively.[40]

FDI also contributes to the GDP growth through investments with high returns and through higher productivity. The study carried out by Borensztein et al. (1998)[41] suggested that a positive effect from FDI on economic growth would occur only above a certain level of workforce skills. Below that level, FDI bears no influence on GDP growth. Obviously, the CEE countries have the preconditions for FDI to be beneficial for economic growth because the level of human capital is sufficiently high.

UNCTAD (2001)[42] data show that foreign affiliates in some of the forerunning countries in the CEE region have reached a relatively high value added as a percentage of the total value added for the country. In the Czech Republic this was 9.2 percent in 1998, in Hungary – approximately 24 percent for both 1998 and 1999, in Slovenia – between 4 and 5 percent for 1998-1999 respectively. This again demonstrates that FDI shows a long-term effect regarding the economic growth indicators. Countries such as Hungary, with an FDI history since 1972, exhibit more convincing figures reflecting the FDI impact on the country's economic development.

In his study of the relation between competitiveness and FDI in CEE[43], Hunya (August, 2000) argued that foreign affiliates (FIEs) are more export-oriented than domestic companies. Their share in exports is high and continues to grow. For the Czech Republic the share of FDI in manufacturing export increased from about 15 percent in 1993 to 47 percent in 1998. These figures were 52 percent and 86 percent for Hungary, 36 percent and 52 percent for Poland respectively. The export orientation of the FIEs varies by country. The FIEs in Hungary and the Czech Republic are almost twice as export-oriented compared to the domestic companies. Poland is different: FIEs are equally export- and local market-oriented. The specifics stem from two main factors: size and demand of the local market and the type of FDI. FDI that are export-oriented are very much "assembly-type greenfield investments".[44]

The share of CEE in EU imports has increased rapidly over the years and this is another indicator of the strengthened competitiveness of these countries. Countries with high foreign penetration such as the Czech Republic and Hungary show an increased share of the EU imports.[45] Although Poland has a high penetration of FDI, the country's share in the EU imports is relatively low due to the prevailing FDI orientation towards the local market. Slovenia has maintained a relatively low level of FDI growth and this may be one of the reasons why Slovenia is losing its competitiveness in the EU market. The other reason of course is the fact that there are more CEE countries that were allowed easier entry into the common market, thus increasing their level of competitiveness.

3.4.2 FDI and the labour market

There are two direct effects of FDI on the labour market: job creation and job distortion. Wage changes, labour productivity and improved skills are other effects related to the labour market.

Table 2-7. Employment at FIEs in CEE

Country	Employment of FEIs as a percentage of total employment (1999)
Bulgaria	5.4
Czech Republic	4.1
Hungary	15.3
Latvia	10.4
Romania	0.9
Slovakia	3.6
Slovenia	5.3

Source: UNCTAD data

While there are no statistics on job cuts by foreign investors in CEE, it is evident that FDI creates new jobs. From almost zero percent of employment in FIEs from the total employment in 1990, the employment rate of foreign companies in the region increased to about 3 percent in 1999.[46] The share of the foreign investment enterprises in the total number of enterprises in the country is another indicator; it is comparable to the relative employment indicator. For instance, FIEs represented over 17 percent of the total number of enterprises and 20 percent of the total value of assets in Hungary in the middle of the last decade of the 20th century.[47] This was the moment when FDI enterprises began to exert influence on the employment in the CEE region. The FIEs in Hungary employed more than 15 percent of the workforce in the country. In Poland and Estonia they employed about 3 percent.

There are studies, although a limited number, that investigated the impact of FDI on the productivity factor in CEE.[48] The results were not always convincingly indicative that FDI significantly increases the level of productivity in the country. Nevertheless, most of the studies showed positive evidence. Barrell and Holland (2000) found that FDI accelerates the restructuring of companies and that FDI is significantly related to labour productivity in most manufacturing sectors. They also demonstrate that the "impact on productivity is predominantly due to the intangible assets introduced by foreign firms, rather than simply the fixed capital investment associated with the FDI". At the same time, in countries with relatively high initial productivity such as the Czech Republic, the contribution of FDI to the increase in productivity is less evident (Djankov and Hoekman, 2000).

The foreign companies, more than domestic ones, display a tendency to restructure their enterprises and therefore optimise the number of employees.

Most local enterprises in CEE were overstaffed. In their search of production efficiency, FIEs have cut jobs in companies they have taken over. On the other hand, greenfield investments created jobs.

In addition to directly created or distorted jobs, there are indirect channels that influence the unemployment rate. Since the investment requires certain facilities and network chains, most of all local suppliers, further job opportunities are provided by FDI. In time, international companies performing in CEE will use more domestic suppliers' networks rather than their own global network. In certain cases, the original suppliers follow their customers in foreign investment (see the case of the automobile industry). Furthermore, FDI may sometimes lead, particularly in monopolistic markets, to the distortion of domestic competitors. As a result, the overall unemployment level may increase. However, taking into account the qualitative aspects of the labour market, the advantages of FDI are significant. The contribution of the FIEs to the improved knowledge and skills of the local employees, as well as to the better attitude to work is of great importance to the overall workforce development in the host country.

Last but not least, is the effect on wage increase although there is no evidence that FDI contributes to the overall growth of the labour wages in the CEE region. Such an effect is more clearly demonstrated in a number of sectors dominated by FIEs such as the financial sector, vehicle manufacturing, electronics, chemicals, and public utility sectors.

3.4.3 FDI spin-off effects

International companies bringing new technologies, management methods and improved organisation of production tend to trigger the spin-off mechanism. Greenfield investors use their own, usually modern, technology. In the case of takeovers and acquisitions foreign investors have a greater tendency to invest in technology innovations than domestic firms. The modernisation of plants and the cleaning-up of production and other facilities is a priority of many foreign investors. The advantage of the FIEs is their easy access to international financing.

In 1993, Siemens of Germany purchased two manufacturing enterprises in electronics in Poland as well as a plant in Hungary. Siemens invested in the clean up of past environmental damage at these sites and in reducing ongoing environmental pressures, such as solid waste generation and air pollution. (OECD, 1999)

The competition in CEE becomes stronger as a result of the increased presence of FIEs. This exerts pressure on local enterprises to perform better and to adapt quicker to market forces. FIEs bring new investors, companies having forward or backward linkages with them, such as banks or insurance

services, distributors and suppliers. FIEs often pay special attention to the development of a local supplier network. The case of the automobile sector in CEE, discussed in this book, is proof of this.

> When HolderBank of Switzerland invested in Hungary's Hejocsaba Cement works, it encouraged the company to obtain ISO 14 001 certification for its environmental management system (it was already certified for ISO 9 000, total quality management). Hejocsaba was the first Hungarian company to be certified under ISO 14 001, and it now requires its suppliers and sub-contractors to meet basic environmental standards. (OECD, 1999)

Companies linked to FIEs are forced to meet high quality standards and environmental requirements in order to comply with EU directives. Thus, FDI imparts an additional positive effect on the host economy in the form of improved product quality, higher productivity through more efficient use of energy, raw materials and other inputs and better services. In addition, FIEs provide or assist in the purchasing of raw materials and intermediaries. They also assist suppliers to diversify by finding additional clients.

> In Poland, Pilkington Glass of the UK (with financing from the EBRD and other sources) has planned a new state-of-the-art glass factory on the site of an existing glass plant, which will be shut down when the new one is completed. The new facility costing about Euro 100 million will use advanced furnace and other equipment to produce sheet glass significantly reducing pollution and other environmental pressures. (OECD, 1999)

4. CONCLUSIONS

To summarise, the effects of FDI on the national economies of the CEE countries are evident though difficult to assess exactly. There are studies that show evidence of positive impact on:

- Economic growth;
- Trade;
- Labour productivity;
- Employment;
- Technology transfer;
- Production efficiency;
- Managerial practices and marketing techniques;
- Workers knowledge and skills.

FDI also displays temporary negative effects, such as:

- Job redundancies and bankruptcy of traditional firms;
- Increased barriers for domestic firms to compete;
- Less use of the traditional local supply and distribution chains.

Naturally, the negative effects do create opportunities in the long run and can therefore also be considered positive.

The impact of the various types of foreign direct investment depends on a number of factors including the specifics of the country and the sector of investment, the investment strategy of the home company, its approach towards the local market and the local partner, and the absorption capacity for new and fast developments of the host economy and firms. These issues are discussed further on in the book, based on companies' investment cases.

NOTES

[1] Council for Mutual Economic Assistance

[2] All joint venture statistics in this Chapter are based on data from UN/ECE and national statistics

[3] Then Federal Republic of Germany (FRG)

[4] Based on a study carried out by the author in the period 1987-1989 at the International Institute for Applied Systems Analysis (IIASA, Vienna); (Razvigorova, Djarova, 1991)

[5] Idem

[6] FIEs are joint ventures and fully owned foreign companies

[7] Central European Free Trade Agreement (CEFTA) with the following members: Bulgaria: Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia

[8] Soviet Union as the main trading partner to all CMEA countries

[9] European Currency Unit (ECU), the predecessor of the Euro

[10] *Note:* Data received from DGII of the European Commission: January to September 1998.

[11] Note: Data received directly from DGII of the European Commission.

[12] Ten countries of Central and Eastern Europe will be considered while discussing FDI statistics for the region. These are: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. These are also the countries from the region that are in accession to the European Union. The choice of these ten countries is based on the fact that they have attracted almost 90 percent of the total FDI inflows to Central and Eastern Europe over a broad geographic coverage (e.g. including Russia, the Ukraine, Belarus and Moldova as well as countries of the former Yugoslavia).

[13] UNCTAD data; this figure does not include the Baltic States and covers Czechoslovakia at that time

[14] UNCTAD - United Nations Conference on Trade and Development

[15] EBRD – European Bank for Reconstruction and Development

[16] WIIW – The Vienna Institute for Comparative Economic Studies; WIFO – Austrian Institute of Economic Research

[17] Czechoslovakia split in 1993 and therefore figures starting in 1993 are often used to provide for the separate consideration of the Czech Republic and the Slovak Republic. This also concerns the Baltic States that separated from the Russian Federation in 1993 as well.

[18] 1996 and 1997 were critical years for the progress in transition for almost all countries. We will come back to this fact later in the book.

[19] Based on cumulative FDI inflow 1993-2000 (including).

[20] The period beginning in 1993 was chosen in order to accommodate the split of Czechoslovakia into Czech Republic and Slovak Republic in 1992

[21] Source: FDI data – WIIW-WIFO database; Population – UN database for 1990-1998, EBRD – for 1999 and 2000

[22] The figure is based on data starting from 1993 in order to account the Czech Republic and the Slovak Republic separately.

[23] There are 15 countries included in the table: Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, Slovakia, Slovenia and the Ukraine. Croatia, Lithuania and Poland data are for 1999. Data on the other countries' FDI sectors are for 1998.

[24] The classification of sectors has two levels: basic and detailed. The basic level defines sectors as Primary, Secondary or Tertiary while the detailed level takes into account the different sectors within each basic category. The Table shows the number of countries in which a particular sector (according to basic or detailed classification) falls in the categories "most important", "very important" or "important". The indicator "Evaluation" in the last column aggregates the importance of every particular sector for the all countries taken into account (15). The Score is calculated as follows: Score = (Most important) x 3 + (Very important) x 2 + (Important) x 1.

[25] UNCTAD classification

[26] World Investment Report, 2000

[27] According to the FDI inward stock, 1999, Ministry of Economic Affairs, Hungary

[28] According to the FDI inward stock, June 2000, PZAIR

[29] Calculations done according FDI inflows 1993-1998, OECD

[30] Barrel R., D. Holland, Foreign direct investment and enterprise restructuring in Central Europe, in: The Economies in Transition, Vol. 8, 2000

[31] The calculation is done according to UNCTAD data on FDI inward stocks structured by the country of origin. The numbers in the table are weighted figures taking into account the investor country's share of the total FDI stock in the host country

[32] Data from Central and Eastern Europe Business Center

[33] Blomstrom, M., A. Kokko, Foreign Direct investment and spillovers of technology, in: International Journal Technology Management, Vol. 22, Nos. 5/6, 2001

[34] Campos, N., Y. Kinoshita, FDI as effective technology transferred: Panel evidence from the transition countries, conference paper, Department of Economics, University of New Castle, Newcastle upon Tyne, version September 2001

[35] Twenty five Central and Eastern European and former Soviet Union countries are taken into account in the study and the data are for the period 1990-1998

[36] Ibid: p. 3

[37] Ibid: p.20

[38] Foreign direct investment (FDI) inwards stock is the value of the share of the capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprise.

[39] Statistical data UNCTAD, 2003

[40] East-West Investment News, UN/ECE, No 2, 1995

[41] Borensztein E. et al., How does foreign direct investment affect economic growth? , Journal of International Economics, Vol. 45, 115-135, 1998

[42] World Investment Report 2001

[43] Hunya studies the Czech Republic, Estonia, Hungary, Poland and Slovenia

[44] Hunya G., International competitiveness impacts of FDI in CEECs, Research Report, WIIW, No. 268, August 2000, p. 22

[45] Ibid: pp.24-25

[46] World Investment Report 2001, UNCTAD, 2001

[47] East-West Investment News, UN/ECE, No 2, 1995
[48] Hunya (1997), Holland and Pain (1998), Barrell and Holland (2000)

PART II

CROSS-BORDER DECISION-MAKING

Chapter 3

Analytical approaches towards FDI

1. INTRODUCTION

This chapter identifies schools in FDI theories and reviews the most important of them. In section 2 five main approaches are discussed from the point of view of the internationalisation of firms. The importance of the integrated theory of FDI is emphasised. The major internal and external driving forces behind cross-border investments are reviewed in section 3. These are the so-called investment objectives respectively investment determinants.

2. FIVE SCHOOLS ON FDI

In their attempt to explain the FDI phenomenon, different authors have chosen different approaches. Some, like Kojima (1973, 1978, 1982, 1990), have sought a macro-economic answer to the question, while others, like Aharoni (1966), have tried to identify the main factors that determine FDI, thus trying to explain its occurrence. Yet another group of authors sought an answer in the field of political economy, while others took an industrial organisation approach.

Since so many authors have developed theories regarding FDI, all with their own approach towards this issue, we have tried to group them. A review of the theory of FDI is also provided in Meyer (1998)[1] where the author applies a different approach of classification.

Following Dunning (1993),[2] the five groups of approaches to FDI that reflect the main schools of thought on the subject will be described. Each school of thought differs significantly. At one side of the spectrum are the political economists and at the other side are the business analysts. In between these two extremes we find the macro-economic, the industrial organisation and the domestic firm approaches. In our discussion of the five schools, several, but not all, of the most important theories are reviewed. Towards the end of this discussion Robert Aliber's theory (1970) will be described in detail. This theory is financially oriented, but it can be considered as a first step towards an integrated theory of FDI. While no all-inclusive theory of FDI exists, the most ambitious attempt so far to integrate each of the main theoretical streams is Dunning's eclectic paradigm. But even this ambitious approach is not a single operationally testable theory that can explain all forms of foreign owned production.

Attempts to theorise about the extent and the pattern of FDI activity are determined by the type of questions that are to be answered. Frequently asked questions are: *Why do firms own foreign production facilities? Why do firms locate their activities in one country rather than another?* And: *Under what conditions do firms engage in FDI?* Researchers ask themselves related, but very different questions. Similarly, they differ in their choice of the unit of analysis. Variables that are considered exogenous by one author may be considered endogenous by another. These considerations are taken into account when distinguishing between the five different schools.

2.1 Approach 1: The Political economists' school

Political economists like Baran and Sweezy (1966), and Cowling and Sugden (1987) can be positioned at one extreme of the spectrum of FDI schools. They view the internationalisation of firms as an inevitable outcome of the capitalist system and as a means of increasing the monopoly power of the investing firms or countries. Since this view is relatively distant from the objectives of this book, it will not be discussed further.

2.2 Approach 2: The Macroeconomic school - the theory of international trade

The modern theory of international trade began with the demonstration by David Ricardo that trade is mutually beneficial to countries. In the Ricardian model, countries export goods that their labour produces relatively efficiently and import goods that their labour produces relatively inefficiently. A country's production pattern is determined by comparative advantage. Ricardo used his model to argue for free trade. His model, however, assumes that labour is the only factor of production. In reality,

however, while trade is partly explained by differences in labour productivity, it also reflects differences in countries' resources. In an effort to explain that international trade is largely driven by the differences in countries' resources, two Swedish economists, Eli Heckscher and Bertil Ohlin (1977) developed a theory, often referred to as the Heckscher-Ohlin theory. In the Heckscher-Ohlin theory of trade, a country that has a large supply of one resource relative to its supply of other resources is abundant in that resource; such a country will tend to produce relatively more goods that use its abundant resource intensively. In other words: countries tend to export goods that are intensive in the factors with which they are abundantly supplied. Because this theory emphasises the interplay between the proportions in which different production factors are available in different countries and the proportions in which they are used in producing different goods, it is also called a factor-proportions theory.

Trade, however, need not be the result of comparative advantage. It can result from increasing returns or economies of scale. That is to say from the tendency of unit costs to be lower with higher output. Economies of scale give countries an incentive to specialise and trade even in the absence of differences between countries in their resources and technology.

While the above theories primarily focus on exchanges of goods and services, the principles of international trade in goods do not differ in their essentials from international trade in factors of production, like transfer of capital, or FDI.[3]

The macro-economic perspective is concerned with the question: '*Why do countries engage in FDI?*' The economists of this stream usually take neo-classical type trade models like the ones mentioned above as their starting point and then extend them in order to explain the patterns of producing abroad. Related to this is the emphasis of the macro-economists on location-specific variables and on the reasons why firms of particular nationalities have different propensities to engage in trade and foreign production.

The most important supporter of this macro-economic type of theory is Kiyoshi Kojima.[4] His theory is an extension of the neo-classical theory of factor endowments to explain trade in intermediate products, notably technology and management skills. Kojima believes that FDI should act as an efficient conduit for trading intermediate products, but that the timing and direction of such an investment should be determined by market forces rather than by hierarchical control.[5] In his view, outward[6] FDI should be undertaken by firms that produce products requiring resources and capabilities in which the home country has a comparative advantage; these firms generate value-added activities for the host countries. By contrast, inward FDI should import intermediate products that require resources and capabilities in which the recipient country is disadvantaged, but the use of which requires resources and capabilities in which it has a comparative

advantage. Kojima's theory pays little attention to the impact of transaction costs on international resource allocation. In the possibility of market failure, not taken into account in Kojima's theory (like in all neo-classical theories), transaction costs lead to a worsening of resource allocation. Nor does Kojima take into account the fact that companies can be both producing and transacting; their trade is not so much based on the optimal distribution of factor endowments, but more on the need to exploit economies of scale and product differentiation. In summary, Kojima's theory is primarily a normative theory that views FDI as an instrument by which the comparative trading advantage of nation states may be better advanced.

2.3 Approach 3: The school of the domestic firm

The third stream of thought is based on the behaviour of the individual business enterprise and draws upon the theory of the domestic firm[7] to explain the existence and growth of the Multinational Enterprise (MNE) and FDI. Economists of this stream[8] look upon the MNE as an organisational hierarchy that internationalises the market for cross-border intermediate products. The methodology and approach used are derived both from Coase, the founder of modern transaction cost economies, and from organisational theorists such as Simon, Alchian and Demsetz, and Williamson.

Hennott extends the theory of the domestic firm, which posits that firms expand in order to economise on transaction costs, to explain that FDI occurs in industries where "transactions are subject to a high degree of uncertainty and where they consist of long term exchanges of complex and heterogeneous products."

The key assumption of his view is that FDI occurs because firm-specific advantages cannot be readily traded.

2.4 Approach 4: The Industrial organisation school - Hymer/Caves' perspective

The fourth school of thought towards FDI addresses the question of why firms of one nationality are better able to penetrate foreign markets than indigenous firms located in those markets, and why they wish to control value-added activities outside their national boundaries.

The common feature of the theories of this approach is that firms develop and then exploit specific advantages or knowledge about products or processes. Proponents of this viewpoint argue that: "direct investment belongs more to the theory of industrial organisation than to the theory of international capital movement."[9]

Stephen Hymer (1960) was the first to give this type of explanation that applies an industrial organisation approach to the theory of foreign

production. Hymer's argument runs as follows: For firms to own and control foreign value adding facilities they must possess some kind of innovation, cost, financial or marketing advantages, specific to their ownership, which is sufficient to outweigh the disadvantages they face in competing with indigenous firms in the country of production. These advantages, which he assumed to be exclusive to the firm owning them (hence the expression 'ownership advantages'), imply the existence of some kind of structural market failure. In seeking an explanation to these imperfections, Hymer turned to theories of industrial organisation as developed by Bain in 1956. This theory of barriers of competition in domestic markets was extended by Hymer to include cross-border activities of firms. Hymer argued that these advantages were either monopolistic or arose from the ability of firms to improve allocation of resources or organise transactions more efficiently. The advantages would allow the owning firm to enjoy an (temporary) economic rent.

In general, Hymer places the emphasis on the organisation of economic activity as a means of advancing monopoly power rather than of reducing costs, improving product quality or fostering innovations. In 1968 Hymer took a different approach, and recognised that MNEs may help to improve international resource allocation.

The implicit assumption in this theory is that firms are reluctant to license or sell their firm-specific advantages or that the anticipated profits associated either with exploiting this advantage through production in foreign subsidiaries are higher than the anticipated profits associated either with licensing these products or processes to host-country firms, or exporting to the foreign country from source-country production.

Caves' industrial organisation approach to the theory of FDI is based on models of oligopolistic competition and stresses that the advantages that enable a firm to attain a large size in its domestic market facilitate the expansion of its foreign subsidiaries. This approach emphasises that once a firm has achieved a superior growth rate, it has a compulsion or incentive to maintain the rapid growth of sales and profits. For an extended period, the growth rate for one or several firms within an industry is higher than for the industry as a whole; the implication of this is that some firms with below-average growth rates will leave the industry. As some firms exit, the surviving firms realise a growth rate higher than that of the industry because they take over part of or the entire market share of the firms that leave. Eventually, the industry becomes oligopolistic, with about four to eight firms remaining. At this stage each firm finds it difficult to maintain its growth rate by capturing market share from its domestic competitors because their cost structures are similar. If a firm wishes to maintain its growth rate, it can enter foreign markets with its traditional products or enter domestic markets with new products. FDI occurs because the firm prefers to cross the political boundaries in its traditional product lines.

2.5 Approach 5: Business analysts' school

Business analysts and organisational theorists can be found at the other end of the spectrum regarding FDI theories. Their approach is to determine the foreign direct investment process by identifying the main factors that influence investment activities. Very often the business analysts' approach is empirical rather than purely theoretical. The best known of the theorists in this group is Yair Aharoni, whose 1966 work[10] aims to "identify the variables that will influence the decision process in order to explain the process itself and to be able to predict behaviour under various conditions." Aharoni describes five elements that he thinks can be delineated in any decision process. These are:

a) *Any choice made in the organisation depends on the social system in which the decision making process takes place.*
   This first element in the analysis of any decision process according to Aharoni is the organisation and the environment in which it takes place. The decision is made in an organisation which has established strategy, procedures, and standard operating policies, which is composed of different individuals, each with its own goals and aspirations, and which is influenced by other super-ordinate systems. The organisation has devised an established 'way of doing things' according to agreed-upon rules, goals and past experience. These rules and specifications influence the behaviour of its members. The individuals within the organisations have established relations amongst each other and with outsiders to the organisation. These relations will also influence any specific decision.
b) *The decision-making process takes a long time.*
   According to Aharoni this dimension plays a very important role in the decision making process. Investment decisions are not so much made at a specific point in time but there is rather a long process, spread over a considerable period of time and involving many people at different echelons of various organisations. The conclusion to invest or to reject an investment possibility is only one step in a long sequence of decisions made during the process, and not necessarily the final one. Any attempt to 'fold' this time element into a 'point' decision would create grave distortions in the understanding of the process.
c) *Decisions are made under uncertainty.*
   From Aharoni's point of view, the avoidance of risk and uncertainty[11] is a very important factor.
d) *Organisations have goals.*
   Any normative analysis must presuppose some model of behaviour, based on certain assumptions about the goals to be achieved by the decision-makers.

e) *There are many constraints on the freedom of action of the decision-makers.*
   Any major decision in business involves a multitude of variables that could be investigated. Thus, a decision to make an investment in a foreign country necessitates search in many directions and the checking of a host of details. Some of the variables, the political environment of the foreign country for example, must, from the investor's point of view, be taken as given. Many can be changed at will, while many other variables may be changed after negotiations.

In trying to describe how a decision to invest abroad is made, some arbitrary point in the continuous process of organisational activities has to be chosen from which the description will start. Aharoni begins the description with an analysis of the forces leading some individuals (the so-called initiating forces) in the company to focus attention on the possibilities of investment abroad and to devote time and other resources to the investigation of this possibility. Aharoni classifies these forces in two categories: forces arising within the organisation, like a strong interest by one or several high-ranking executives in the organisation; and exogenous factors, stemming from the environment. The most important factors in the second category include:

- An outside proposal, provided it comes from a source that cannot be easily ignored. The most frequent sources of such proposals are foreign governments, the distributors of the companies' products, and its clients.
- Fear of losing a market.
- The '*Band Wagon*' effect: very successful activities abroad of a competing firm in the same line of business, or a general belief that investment in some area is a 'must'.
- Strong competition from abroad in the home market.

According to Aharoni it is, in any specific case, difficult to pin down one reason for a decision to look abroad, or to precisely identify the initiator of a project. The decision results from a chain of events, incomplete information, activities of different persons, and a combination of several motivating factors, some of them working in favour of such a decision, some of them against it.

In general, the decision to look abroad is brought about by the interaction of several forces, partly environmental and partly inside the organisation, influencing different persons at different times.

2.6 Integrated theory of FDI

The middle three main theoretical schools of thought mentioned above (approaches 2, 3 and 4) are obtained by integrating the theory of the firm and the theory of trade. These theories provide an answer to the question of why firms produce abroad. A different question asked by Robert Aliber in 1970 is why firms finance their foreign assets in their domestic currencies. Here the theory of International Capital Markets comes into the picture. Aliber answers this question in terms of the ability of firms from countries with strong currencies to borrow or raise capital in domestic or foreign markets more cheaply than firms from countries with weak currencies can. This in turn enables the firm to capitalise their expected income streams at different rates of interest. Aliber further argues that structural imperfections in the foreign exchange market allow firms to make foreign exchange gains through the purchase or sales of assets in undervalued or overvalued currency.

In summary, according to Aliber the uniqueness of the MNE is its ability to dominate its geographically dispersed assets in different currencies, and by so doing, to take advantage of structural or transactional imperfections in international capital and foreign exchange markets. By trying to answer the question of financing FDI, Aliber tried to incorporate more variables and therefore come to an all-incorporating theory of FDI. His theory is widely regarded as an extension of the portfolio capital theory to incorporate market failure rather than as a theory of FDI per se, as he intended it to be.

Other authors also tried to offer an all-including theory of FDI. The most important of these authors is John H. Dunning, who, in his Eclectic Paradigm[12] sought to offer a general framework for determining the extent and pattern of both foreign owned production undertaken by a country's own enterprises and also that of domestic production owned by foreign enterprises. It is not a theory of FDI in the Aliber sense of the word, but rather of the activities of enterprises engaging in cross border value-adding activities.

The eclectic paradigm stands at the intersection of the macro-economic theory of international trade and the micro-economic theory of the firm. It starts with the acceptance of much of the traditional trade theory in explaining the spatial distribution of output (so called Heckscher-Ohlin-Samuelson output). In the Heckscher-Ohlin-Samuelson model, the choice between domestic and foreign production is determined by geographical distribution of immobile factors and location advantages. In the eclectic paradigm the firm is, however, no longer a black box, both the distribution of factor endowments and the modality of economic organisation are relevant to explaining the structure of trade and production. The theory is in essence an exercise in macro-resource allocation and organisational economics.

The eclectic theory specifies a set of three conditions that are required if a firm is to engage in FDI. These are:

- *Ownership specific advantage:*
  The firm must possess net ownership advantages vis-à-vis firms of other nationalities in servicing particular -mainly foreign- markets. These firm-specific (or ownership-specific) advantages largely take the form of intangible assets, which are, at least for a period of time, exclusive or specific to the firm possessing them. Thus the distinction of the ownership advantage is between structural and transactional market imperfections.
- *Internalisation advantage:*
  Assuming that the condition in the preceding paragraph is satisfied, it must be more beneficial for the enterprise possessing these advantages to use them for its own benefit rather than to sell them to foreign firms. Alternatives to internalisation, such as licensing, management contracts, and franchises must be less feasible methods of appropriating the firm-specific advantage.
- *Location advantage:*
  Assuming that the conditions in the two preceding paragraphs are satisfied, it must be profitable for the enterprise to locate abroad, that is, to utilise these advantages in conjunction with at least some factor inputs outside its home country.

These three advantages (OLI-advantages) are required to offset the costs incurred by the MNE of operating at a distance from its home base. These costs like control and communication costs are not incurred by local operations. The advantage must be specific to the MNE; if they would be available to local firms, the MNE would not be able to offset the costs of operating at a distance. The FDI decision depends on which option presents the best net return, when the risks associated with each alternative are taken into account.

While the eclectic paradigm is often called the most ambitious attempt to integrate each of the main theoretical streams mentioned earlier, it is no more than a general paradigm of MNE activity; not a single operationally testable theory that is able to explain all forms of foreign owned production.

Or, as Dunning says: “There will never be an all-embracing explanation of international production, only a correct answer to particular questions, each of which may add to our understanding about cross-sector organisation of economic activity.”

Dunning has further extended the view of the OLI paradigm by taking into account modern developments of recent times. He pays particular attention to the type of corporate assets and the interest of companies in obtaining ownership of assets abroad. The nature of the corporate assets has changed over time: once tangible assets were important and therefore dominated within the understanding of “ownership of assets”. Nowadays,

intangible assets receive more and more attention. These are: human capital, goodwill and organisational capability.[13] The emphasis of ownership widens, starting from ownership of land and property, adding to it machines, buildings, financial assets and property rights and finally intellectual assets and relational assets (called R-assets by Dunning). The R-assets are the basis of the networking that can affect the investment choice of the investment location. It certainly also has an influence on the organisational form of investment. It is obvious that multinationals, by their nature, have more network advantages than other companies. Relational assets are country specific. In order to provide a sustainable competitive advantage they have to be unique and imperfectly imitatible. Unlike most other assets, R-assets are only of value when combined with those of other companies. In addition they do not deplete when used. It is important that such assets cannot be owned, they can only be utilised, partly controlled, developed and perhaps influenced. Intangible assets in general can hardly be transferred over borders. The increasing importance of such assets makes the global location portfolio of investments a crucial factor for the competitive advantages of firms.

3. OBJECTIVES AND DETERMINANTS OF FDI

One of the main driving forces behind FDI is the investment behaviour of companies that are potential cross-border investors. Companies usually make their decisions on the basis of internal (for the company) and external factors that, when combined, provide investment opportunities and options. Some issues related to these factors were discussed in the previous paragraphs. In the present paragraph the emphasis will be given on the following:

- The objectives of the company, a potential cross-border investor, represent a strategic part of the internal driving factors to search for investment opportunities;
- Investment determinants, which combine the most important external factors defining the investment environment.

3.1 Companies' investment objectives

Company's investment objectives can be divided into three groups and are widely discussed in the literature. One group of objectives is specifically aimed at the 'ultimate' objective: *selling the product.* This is called a *market-seeking objective.* International companies are forced to enter new markets because if they would not do so while their competitors would, they would loose relative size and competitive power. Another kind of investment is aimed at reducing costs or realising economies of scale.[14] This is called the

efficiency related objective. Finally, investments can be aimed at obtaining resources, the so-called *resource seeking objective.*

The three groups of objectives will be described by extracting the most frequently quoted characteristics in the literature.

Resource related objectives

Companies with this kind of objectives (called in this case resource seekers) place their priorities on obtaining specific resources at a lower cost abroad. There are three kinds of resource seekers: seekers of physical resources,[15] seekers of labour resources[16] and seekers of technological resources.[17]

Market related objectives

Companies with market related objectives want to sustain or protect existing markets, to explore new markets or to replace exports to certain markets with direct investment. Apart from market size, prospects for market growth and most importantly the actions of host governments to encourage investments (trade tariffs and import controls), four reasons that prompt firms to engage in foreign production can be identified:

- Main suppliers or customers set up foreign producing facilities;
- Products frequently need to be adapted to meet local tastes;
- Production and transportation costs are lower;
- Having a physical presence in the leading markets.

Efficiency and strategic asset related objectives

To rationalise the structure of the established portfolio of activities, whether resource related or market related, determines another set of objectives concerned with efficiency and the management of strategic assets. Very often at the core of the efficiency is the effect of economies of scale that can be achieved through geographically distributed activities. The management of the strategic assets is primarily related to risk diversification and this often requires optimal location of a company's assets abroad. Companies that have strategic asset related objectives promote their long-term strategic objectives via the expansion of the firm's existing portfolio of assets. This often strengthens a company's own position or weakens that of its competitors.

Other reasons to invest, which cannot be assigned to the three categories described above are the following:

- *Escape investments:*

  Foreign direct investment of which the main objective is to escape the restrictive legislation or other policies of the investing company's home government.
- *Support investment:*

Investments that intend to support activities developed by the rest of the enterprise.

– *Passive investments:*
  These investments require no involvement in their management. They are closer to portfolio investments rather than to FDI.[18]

Investment objectives adapt a concrete meaning when related to a particular investment location and particular investors. Specific investment objectives towards Central and Eastern Europe as an investment area are discussed in Chapter 5.

3.2 FDI determinants

External factors that may influence the occurrence of FDI have always been a subject of interest for many authors in the field. To provide more insight on FDI determinants UNCTAD and OECD survey the evidence regularly.[19] The aim of the surveys has been a better understanding of the external factors that influence the location decisions of transnational corporations. Following the patterns, recognised by the reports of UNCTAD in the past decade, in this section comments will be given on particular characteristics of a number of mostly quoted determinants:

– *Market size and characteristics*
  The size of the host country is positively related to the foreign direct investment. This hypothesis is broadly supported. Market size is usually measured in terms of GDP. The perceived growth rate of GDP may be more important than GDP size, though this might not necessarily be the case.
– *Costs*
  Investments tend to be greater in an industry where host country production costs are relatively lower than home country production costs. However, the level of wage costs should also be compared with the skills and labour productivity.
– *Economies of scale*
  This aspect may have conflicting consequences. On the one hand the rational is that where economies of scale represent entry barriers, FIEs, usually larger than local producers, may find it easier to overcome these barriers.[20] On the other hand, if a particular industry is characterised by high entry barriers (economies of scale), the fewer plants a multinational is likely to have globally, therefore the lesser the chance that a host country will receive one of them.
– *Skill intensity*
  This determinant concerns the availability of highly skilled labour in the host country. It is complementary to R&D intensity.
– *Research and development (R&D) intensity*

Assuming technology to be a key ownership advantage of FIEs, FDI will be relatively more important in those industries where such an advantage would be of most value. This means a positive relationship between the share of foreign firms in a local industry and R&D intensity at industry level.

- *Concentration*
  Concentration of industry in a country may stimulate a firm to engage in FDI.
- *Firm size*
  The rational is that the higher the size of the local firm, the higher the share of FDI. Results are often mixed because, on the one hand, large local companies may deter foreign investors but on the other hand, foreign investors have an inherited importance in scale intensive sectors.
- *Capital requirements*
  This concerns capital-intensive industries where a substantial initial and total investment is required.
- *Multiplant operations*
  The characteristics of the industry allow multi-plant operations.
- *Advertising intensity*
  In industry where product differentiation and marketing are part of the ownership advantages, advertising is a "must". In this case the environment for advertising in the host country is essential (e.g. attitude and perception of customers).
- *Protection*
  A determinant that plays a smaller role: the assumption that FDI will be positively related to levels of effective protection against imports is generally not confirmed.

Some determinants that could be important, like geographical proximity, cultural and historic links, prior involvement, consumers' behaviour, the state of the infrastructure and the availability of incentive schemes have not been researched very thoroughly. Investment determinants obtain specifics when related to a concrete investment location. In addition, different investors perceive their importance differently. The investment determinants in connection with the countries of Central and Eastern Europe will be further discussed in Chapter 4.

4. CONCLUSIONS

There is a large number of FDI theories of which the core emphasis can vary from macro- to micro- and business economics considerations. They have been grouped according to five schools. These approaches are the

political economists' school, the macro-economic school, the industrial organisation school, the domestic firm school and the business analysts' school.

The basic principles of these theories are valid for the investment process to Central and Eastern Europe (CEE), but their application should be adapted. At the same time, the FDI experience in this region has just more than only a decade worth of history and this hardly provides a solid basis for theoretical conclusions. In our opinion, what is most important at this stage is to gather as much empirical information concerning companies' investment behaviour in CEE countries as possible. We discuss five branches in the case studies chapters of this book (Chapters 6 to 10). This provides a consolidation (or not) of some of the hypotheses and conclusions made by different researchers in the field. Examples of attempts at such a consolidation are also the works of, amongst others, Estrin, Hughes and Todd (1997), Michalet (1997), Meyer (1998) and Estrin, Richet and Brada (2000).

Prior to defining the cross-border investment objectives, companies need to get a clear picture of the characteristics of the investment area. These characteristics are reflected in the values of the investment determinants. Investment determinants are the political, economic, business and socio-cultural factors that define the attractiveness of an investment area for companies. The characteristics of Central and Eastern Europe as an investment area are paid special attention in Chapter 4.

NOTES

[1] Meyer, K., *Direct Investment in Economies in Transition, Part Two,* Edward Elgar Publishing Limited, Cheltenham, UK, Northampton, MA, USA, 1998

[2] Dunning, J., *Multinational enterprises and the global economy,* Chapter 3 and Chapter 4, Addison Wesley, 1993

[3] Krugman, P., Obstfeld, M., *International economics,* Harper Collins, 1994

[4] Kojima, K., *Direct foreign investment: a Japanese model of multinational business operations,* Praeger Publishers, New York / Toronto, 1978

[5] The author makes no difference between governmental or holding-wise hierarchical control. In his view the market forces, when given the freedom to work, will sort things out (comparable to the 'Invisible Hand' of Adam Smith).

[6] While Kojima calls this 'outbound', in this book the UN and OECD terminology is used.

[7] The standard economist's theory of the firm is that firm boundaries are drawn in ways that achieve the best possible trade-off between transaction and rigidity costs.

[8] [8] Including the authors Buckley, Casson, Hennart, Rugman and Teece

[9] Kindleberger, C., *International Capital Movements,* 1970

[10] Aharoni, Y., *The Foreign Investment Decision Process,* Harvard University, Boston, 1966.

[11] If one assumes that the decision-maker knows the problem and its alternatives, and can state the probabilities of each one of the consequences, then the decision is made under risk. When the probabilities cannot be objectively stated, the decision is made under uncertainty.

[12] Dunning, J., *The eclectic theory of international production,* presented to a Nobel symposium in 1976 in 'the international allocation of economic activity'

[13] The author had the pleasure to listen to the lecture of Prof. J. Dunning at the regular conference of EIBA, Maastricht, 11 December 2000

[14] e.g. advantages of scale

[15] e.g. oil wells in multinational enterprise (ME)

[16] e.g. cheap and skilled labour in CEE

[17] e.g. strategic alliance concluded by SEA firms with companies in the US or the EU

[18] Dunning, J., *Multinational enterprises and the global economy,* Chapter 3 and Chapter 4, Addison Wesley, 1993

[19] All World Investment reports touch upon the issue of investment determinants. Some special issues were dedicated explicitly to this topic: *Determinants of Foreign Direct Investment: A survey of the evidence,* UN, New York and Geneva, 1991; *Trends and Determinants,* UN, New York and Geneva, 1998; OECD Working papers on international investment, e.g. Thomsen, S., *Investment Patterns in a Longer-Term Perspective,* OECD, Paris, No. 2, April 2000

[20] However, the advantage of these FIEs may also be the ability to acquire the necessary funds.

Chapter 4

Central and Eastern Europe as an investment area

1. INTRODUCTION

This chapter discusses the characteristics of Central and Eastern Europe (CEE) as an investment area and the investment determinants that derive from that. The chapter gives a broad macro- and microanalysis of the region. First of all, (section 3) we compare CEE with other emerging markets. As the transitions from authoritarian, centrally planned economies to democratic, market driven economies are unique for CEE, we discuss their main aspects (section 4). This includes economic growth in the region and the countries that make it up, the nature and the current state of the transition processes, privatisation, the business environment as it is today and certain characteristic features that distinguish CEE from other emerging markets (section 5). Investment determinants are derived from the analysis of the macro-, micro- and specific characteristics of CEE (section 6). These investment determinants are of paramount importance in company's FDI decision-making.

2. APPROACH TO THE ANALYSIS OF CEE AS AN INVESTMENT AREA

There are three main aspects that companies analyse when exploring the investment opportunities in a region or a country:

– Regional and county's macroanalysis on the basis of which investors chose a region or a country to investigate further;

– Microanalysis of the region or country;
– Specific investment opportunities.

The regional and country's macroanalysis usually concerns macro economic, political and social indicators that very often serve as inputs to county's risk analysis as discussed in Chapter 1. The core of this analysis is the political and economic stability. Investors are looking at such issues as the establishment of democratic governments; clear moves towards a market economy; resolution of foreign exchange; convertibility of currencies and profit repatriation issues.

The microanalysis covers specific market considerations, economic policies such as privatisation and foreign investments, legislative and regulatory environment, business infrastructure, etc. In this respect CEE as a relatively new investment area is very much featured by the change process that started in 1989. Therefore, the microanalysis is determined by the outcomes of the transformation process, which differs per country. In addition, Central and Eastern European countries share common characteristics inherited from the past, which in some cases serve as advantages and in others as disadvantages for the foreign investor.

The specific investment opportunities can be analysed against such criteria as possible investment forms, availability of suitable local partners, investment incentives, level of returns.

Potential investors usually mix up elements from the three analyses in a way that corresponds to their individual objectives and weigh the outcomes. Foreign investors assess that the most representative elements for CEE are political and economic stability, market, infrastructure, return, investment opportunities, legislation and bureaucracy (see Table 4-1).

Table 4-1. Main considerations to invest in Central and Eastern Europe

Criteria	Number of quotations
Political/economic instability	70
Market considerations	53
Infrastructure	25
Returns uncertain	25
No suitable opportunity	23
Legislative and bureaucratic problems	16
Number of interviews	*129*

Source: OECD[1]

3. CEE AND OTHER EMERGING MARKETS

As data on FDI show (Chapter 1), Central and Eastern Europe has become one of the attractive regions to invest. Although the total amount of

foreign capital invested there is lagging behind other emerging markets as Asia and Latin America, in relative terms it is quite advanced:

- It shows the best FDI figure as a percentage of GDP;
- It has gained the highest speed in attracting FDI.

Central and East European countries did have their ups and downs in the last decade of the 20th century but none of them have regressed from further development. The countries have shown political stability and steady economic progress. One cannot say the same for the Asian countries that led in terms of absolute value of FDI. The Asian crisis has triggered the political as well as the economic stability of the region that only recently shows recovery signs. Latin America has approached the end of the century as the most promising region as far as FDI is concerned. The region now suffers from the spill over effect of the Argentinean crisis that started in 2001.

The interesting fact is that region's risks of CEE, Asia and Latin America have converged in the last years of the past decade. The three regions were judged as being economically, politically and financially equally risky. Only Central and Eastern Europe has shown an increase in investors' confidence in the period 1993–2000 (see Table 4-2). The political risk of CEE has gone down while it increased in the other two regions. All three regions have become less economically attractive by the year 2000 with CEE performing again better than the other regions.

Table 4-2. Regions' risk (the lower the lesser risk)

Risk	Regions	1993	2000
	Latin America	51.7	50.9
Total risk	Asia	65.6	53.5
	CEE	43.4	53.1
	Latin America	14.4	12.2
Political risk	Asia	17.9	13.4
	CEE	11.4	13.3
	Latin America	14.0	8.2
Economic risk	Asia	15.5	9.2
	CEE	11.1	8.5

Source: Euromoney for 1993 and 2000

Below we give some details of the development of world markets during the past decade.

- *Asia*

  By 1993 Asia was booming registering a sustained growth with China claimed as a miracle for its buoyant economic expansion. Therefore, many investors perceived China as 'the market of the future' with its huge market size[2] and extremely low labour costs. The Philippines have introduced incentives to foreign investors. Singapore and Taiwan were progressing into the first ten places ranked in economic performance indicators. Singapore has become 3rd in 1996, but Taiwan has never made

it to the top ten. The crisis that started to accumulate in 1996 has shown its results from 1997 onwards. Although the attractiveness of Asia has slipped because of the crisis, the region offers advantages in comparison to the CEE market. It offers high demand (six times larger market), inexpensive labour and land, well trained and market oriented workforce, better business and physical infrastructure. This region is especially attractive for Japanese investors based on the geographical proximity and cultural and historical links.

– *Latin America*
As of 1992 Latin America has become an obvious destination for foreign investors. At the same time, it seems that the region can hardly be considered homogenous. Brazil has been in a deep crisis at the beginning of 1992 as a combination of political scandal and inconsistent economic policy. It has performed worse than Romania at that time. Mexico, being very attractive until 1995, has had problems with its peso and has lagged behind although to a lesser extent than Brazil and Argentina as of 2001. Small countries in Latin America seem to be more stable in terms of politics and economy. Peru, Chile, Colombia, Bolivia, Ecuador, Panama and Venezuela have been progressing during the past decade (with a very small fall in 1995).

– *Western Europe*
Western Europe faced increasing interest rates as of 1993 that were the main cause of a slight recession. Especially difficult were the times for Germany that has suffered from high inflation and costs of reunification, low domestic and foreign confidence. It was only Luxembourg that met the Maastricht criteria at that time. The oldest member-countries of the European Union have been less attractive as investment destinations than Ireland, Portugal, the Scandinavian countries and Spain. In addition to the recession the core countries of Western Europe suffered from saturated markets and more cautious spending patterns of their consumers. The high labour costs make most of the West Europe countries less attractive for capital investments. At the same time the unified market of the EU offers new opportunities. It is one of the most attractive investment areas for hi-tech investments. It provides strong distribution systems and a well-developed business infrastructure. Western Europe is a mature, stable and a reliable market from an economic and political point of view.[3] Despite its ups and downs the EU has been and is attracting the largest portion of FDI in the world. As an illustration, Benelux (with a total population of 26 million) has attracted in 1998 and 1999 ten times more of world FDI than CEE (with a population of over 300 million: UNCTAD country-

coverage of CEE – see Chapter 1). Portugal, Spain, Greece and Italy (with population four times smaller than that of CEE) receive three times more of the world's FDI. Furthermore, even though the European Union is the largest investor in CEE, the economies in transition attracted only 3 percent of the EU investment outflow in 1998. In 1998, Germany, the most important provider of FDI to CEE, had invested only 5 percent of its FDI outflow there.[4] The two countries that can be compared to the member-states at present are the Czech Republic and Hungary. Their level of FDI inflow per capita is comparable to the least developed countries in the EU.

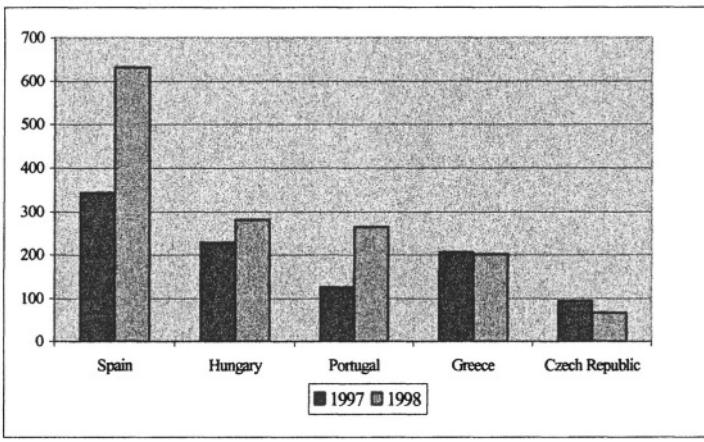


Figure 4-1. **FDI per capita in selected countries (in US$)**

– *Central and Eastern Europe*

In their irreversible process of transformation the countries of Central and Eastern Europe have shown differences not only in their political stability, but most of all in their pace of economic reforms. The Czech Republic, Poland and Slovenia were the fastest risers although the country that attracted most foreign investments was Hungary. Due to a slow down in the reform of the country's financial sector and in privatisation, Hungary got a somewhat more critical view from Western investors in the mid-1990s. Bulgaria and Romania have struggled longer with their economic reforms, especially with privatisation. Therefore they have not been preferred as FDI destinations. The two countries have speeded up in the last three years of the past decade and especially Bulgaria has advanced substantially politically as well as economically. Latvia, Lithuania and Estonia scored high in their economic performance component of the country risk analysis, even higher than countries like Slovenia, Hungary, the Czech Republic, Poland and Slovakia.[5] Estonia is substantially ahead of the other two Baltic countries at present. In 1996 when the situation in

none of the other regions improved, the countries in CEE have benefited. Especially the countries from Central Europe that furthered their economic reform programmes have attracted the attention of foreign investors. It has become clear that ten CEE countries are potential EU members with different time schedules for entry. The accession perspective has its own effects on foreign investments especially on investors from the EU countries.

One of the most attractive features of the CEE region in the last decade of the 20^{th} century was the transition process from centrally planned to market economies and from totalitarian political regimes to democracy. This was without doubt the major reason for foreign investments to go into the region. Although the share of CEE in total world FDI is negligent as compared to other regions (average 3% for the decade), it has grown six times since the 1980s. As we have shown in Chapter 1, no other region has shown such growth. Asia and Latin America doubled their shares, the EU maintained the same level, and the US has lost one third of its share. The decade was turbulent for Asia and a slight recession hit the EU. CEE was the only region that seemed not to be influenced by the economic and political unrest elsewhere. The transition process, becoming irreversible, has spread well among the countries of the region. It has been a process well locked within the region, highly supported by international institutions such as the World Bank, the International Monetary Fund and the European Union. This made its success quite independent of developments in other regions. The latter is also supported by the fact that CEE has formerly been negligibly integrated into the world economy. The biggest stress the countries have experienced in the beginning of their transition period has come from their disconnection from the markets of the former Soviet Union. In the following section we will further discuss which specific features of the transition process have made the CEE region an attractive place for foreign investors.

4. THE TRANSITION PROCESS OF CENTRAL AND EASTERN EUROPE

Until now, there is no precedent for the complexity, the scale and the speed of the transformation processes in CEE countries. The most important elements of this process are:

- *Mass liberalisation of prices and trade in a short time.* In almost all countries the price and import liberalisation reached about 95 percent by 1995.

- *Drastic cuts of government subsidies to loss making industries.* All CEE countries have accepted as a general principle the elimination of government subsidies to both industries and consumers, and of subsidies inhibiting the competition and efficiency of a free market system. It is interesting to note that state intervention in companies' decisions is quite high for the region's front-runners such as Hungary and the Slovak Republic. The lowest state intervention index, defined by the EBRD to measure state influence on pricing, wages, employment, investment, dividends, etc. is reached by Estonia, followed by Poland and Bulgaria.[6]
- *Restitution of land and property that were nationalised after the Second World War.* The restitution includes houses, shops, small factories, hotels, villas, small dairy farms, agricultural land, etc. It is difficult for Western people to grasp the scope of projects in which a very large share of the national assets changed ownership overnight.
- *Privatisation of large state property.* The number of state enterprises to be privatised in Bulgaria, the Czech and Slovak Republic, Hungary, Poland and Romania was between 5 000 and 10 000. The biggest single sale of companies ever seen – and most likely ever to be seen - in the world could be seen in CEE.
- *Explosion of private business.* More than 5 million small and medium size private companies (SMEs) were established in the CEE region.[7]

4.1 Economic growth

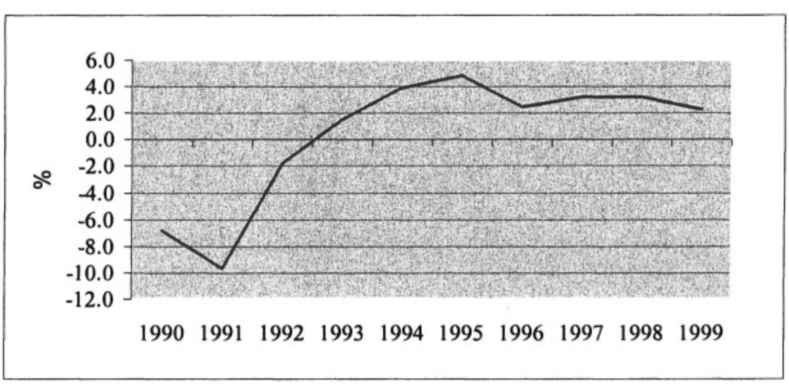


Figure 4-2. **Weighed growth rate for 10 countries**[8]

The overall goal of the transition process in CEE is to create the conditions for economic growth and prosperity.[9] According to the European Bank for Reconstruction and Development (EBRD)[10] and the Geneva-based

ECE[11], this process was claimed to be successful already as of 1991. The first indicator to show this was the rapidly increasing growth rate especially between 1991-1995 (see Figure 4-2).

Although the countries performed differently in terms of economic growth, we can distinguish three groups:

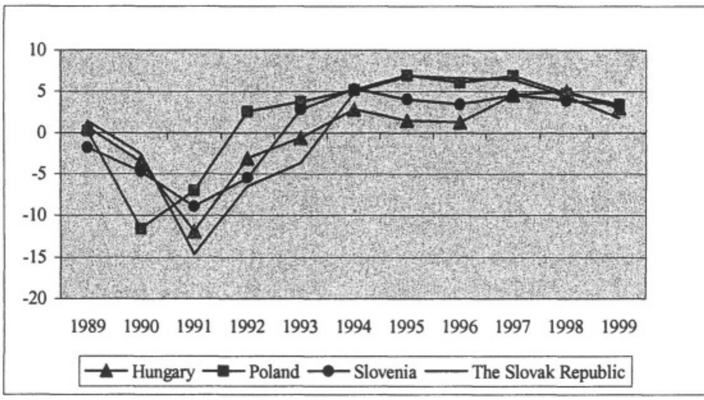


Figure 4-3. **GDP growth rate in Hungary, Poland, Slovenia and Slovakia**

- The (first) group of Hungary, Poland, Slovenia and the Slovak Republic (that has encountered a deep fall in 1990-1991): rapid growth until about 1995-1996 and stable growth afterwards. One should notice that the Czech Republic does not belong to this group (see Figure 4-3).

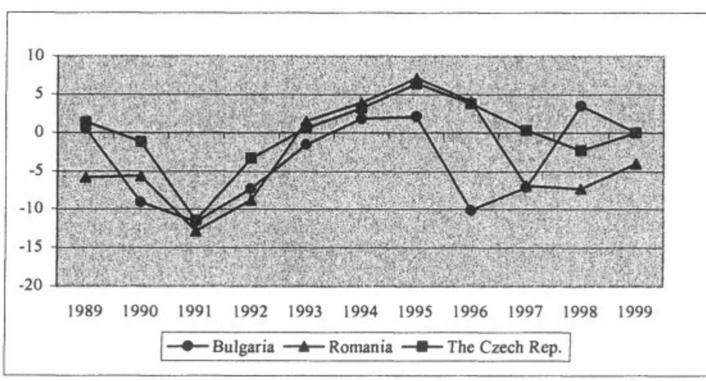


Figure 4-4. **GDP growth rate in Bulgaria, the Czech Republic and Romania**

- The (second) group of the Czech Republic, Bulgaria and Romania: rapid growth until about 1995 and rapid fall around 1996. The Czech Republic has shown more crisis resistant although the financial crisis of the country has been holding it back for about 3 years with a slow

recovery after 1998. Bulgaria and Romania were badly prepared for the deep economic as well as financial crisis that brought these countries back to their 1990 level (see Figure 4-4).

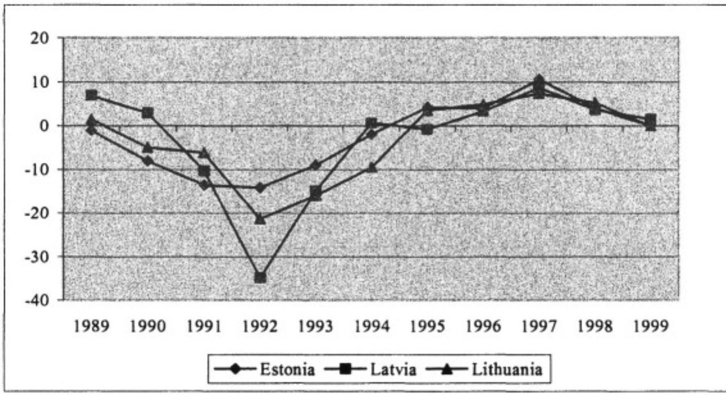


Figure 4-5. **GDP growth rate in Estonia, Latvia and Lithuania**

– The (third) group of Estonia, Latvia and Lithuania that has a very similar behaviour to the first group but differing by the fact that the deep fall came one year later, in 1992. Since then these three countries have grown economically and have shown stability. Especially Estonia is well performing (see Figure 4-5).

Although all ten countries show saturation in their economic growth as of 1997, the growth for the region as a whole was 5.5 percent in 2000 on a weighted average basis, the second best performance since 1995.[12] The average annual GDP growth was about 3 percent for the period 1994-2001. Its level for 2002-2003 is estimated at 3.3 percent. For comparison, the GDP of the EU member states grew annually with an average of 2.6 percent in the period 1994-2001 and the estimated annual growth for 2002-2003 is 2.2 percent.[13] The growth of Poland is estimated lower than that of the Czech Republic, Hungary, the Slovak Republic, Slovenia and the Baltic states where it ranges between 3 and 5 percent. The figures for Bulgaria and Romania might be even more optimistic in the coming years.

The economies of the CEE countries have reached a high level of economic dependency from the EU member states by the end of the past century in terms of trade. Nonetheless, the recent EU recession had a negligible influence on CEE growth. Export of CEE to the EU accounted for about 50 to 60 percent of total exports in 2001. In addition, the share of exports in GDP of the CEE region is at the level of about 50 percent.[14] The possible negative spill-over of the economic slowdown of the EU to the CEE economies was prevented by two main factors: growth in domestic demand

and retained trust of foreign investors. In all countries except Poland private consumption grew strongly reflected for instance by continued growth of retail sales in successive years.

The expectations for sustained growth and stable domestic consumer demand across the CEE region combined with the expected EU recovery, makes the outlook for Central and Eastern Europe favourable for foreign investors in the coming years. A survey carried out by UNCTAD/AFII/ Andersen[15] in 2001 shows that 2/3 of the respondents regard CEE as one of the most stable and promising investment regions for the coming 3 to 5 years.

4.2 Progress in transition

The progress of the transition clearly influenced foreign investments. At the same time, this explains the uneven spread of FDI in the region.

Table 4-3. Progress in transition

Countries ranked by commutative FDI per capita	Private sector share of GDP in %, mid-1999	Transition indicators average*	Cumulative FDI inflows per capita 1990-2000
Czech Republic	80	3.49	2242
Hungary	80	3.69	2119
Estonia	75	3.46	1688
Poland	65	3.48	1044
Latvia	65	3.38	1033
Slovenia	55	3.24	893
Slovakia	75	3.33	795
Lithuania	70	3.13	658
Bulgaria	60	2.83	403
Romania	60	2.76	290

Source: EBRD (Transition indicators), WIIW (FDI inflows)

Notes: * large-scale privatisation, small-scale privatisation, governance & enterprise restructuring, price liberalisation, trade & foreign exchange system, competition policy, banking reform & interest rate liberalisation, securities markets & non – bank financial institution

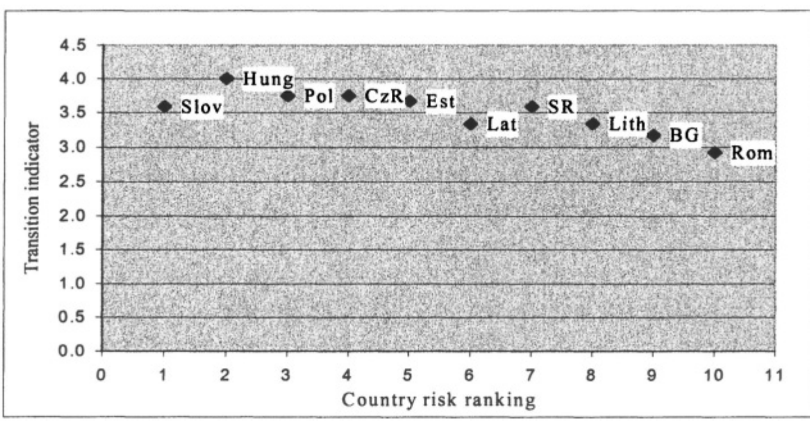
According to UNCTAD (1998) the 1997 rank correlation coefficient between the FDI stock and the transition indicator for the region's 16 countries[16] was 0.91 and that between FDI flows and the transition indicator 0.85, showing a high level of interdependence. EBRD[17] also suggests that

the progress in transition is the main determinant influencing the extent of investment.

The term "transition" is understood to include a process of macroeconomic stabilisation, liberalisation of the domestic economy and trade, privatisation and establishment of market-oriented institutional legal structures. As a consequence, the economy shifts from being driven by supply to being driven by demand, increasing its sensitivity to consumers both domestically and internationally.

The progress in transition, as reflected by private sector development and all transition indicators as identified by EBRD[18], shows a direct link to the accumulated FDI inflow per capita (see Table 4-3). The best countries in terms of cumulative FDI inflow per capita are also the best performers in terms of private sector share of GDP as well as progress in the transition process.

Some CEE countries perform better than others in their transition to a free market economy. There are two main reasons for this: the starting conditions of each country were different and the implementation of the reforms differs per country.



Source: **EBRD transition indicator (averaged); Euromoney country risk ranking (2000)**
Figure 4-6. **Positioning of the ten countries on country risk and progress in transition**

The starting conditions concern such elements as external and internal debt, credit and investment rating with the world financial community, share of foreign trade with CMEA countries, level of market and industrial infrastructure from before World War II, availability of skilled and disciplined labour force, geographical and cultural proximity to Western Europe, lobbying power abroad. In all these elements Central European countries (the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia) have clear advantages. The same countries with the addition of

Estonia also show higher governance culture in the design and the implementation of the economic reforms.

From the economic performance, it is more or less evident which are the "front runners" of the CEE countries. This is not only defined by the economic indicators, but also by the views of many Western experts and consultants who have direct observations in the countries of the region. Their opinions may differ concerning some particular issues, but in general they coincide with what the EBRD has presented in its transition reports (see Figure 4-6). The journals *International Investor* and *Euromoney* also share the view that the 'group of ten leaders' among CEE countries consists of (in alphabetic order) Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia[19].

4.3 Privatisation

One very important factor influencing foreign investments in CEE is the privatisation of state owned enterprises. It is important for two main reasons:

- Privatisation offers unique one-off investment opportunities;
- Privatisation contributes to the development of a free market economy.

Since 1990, more than 60 000 medium- and large companies were privatised in CEE, ten times more than all privatised firms in the rest of the world in the previous 10 years.[20] The state owned industry before the transition was 97 percent in Bulgaria, 97 percent in Czechoslovakia (then), 81.7 percent in Poland and 65.7 percent in Hungary. In 5-6 years following 1989 the share of the private business was already down to 67 percent in the Czech Republic, 68 percent in the Slovak Republic and 45 percent in Poland.[21] The situation at present is that the state holds majority stakes in utility companies, some banks and a few companies.

The privatisation has been carried out differently in the different countries of the region. This is directly related to three main conditions for foreign investments namely:

- Time and form of the offer;
- Restrictions of the offer;
- Status of the object for sale.

The Czech Republic (and the Slovak Republic as part of Czechoslovakia before 1992), Hungary and Poland were leading with respect to the speed of privatisation. Takeovers and majority participation were open to foreigners earlier than in the other countries of the region. Slovenia for instance, had a very conscious approach to foreign investors. One of the forms of privatisation was the mass privatisation method that took place in the Czech Republic, Bulgaria, Lithuania, Latvia and to a lesser extent Poland (10% of all industry in terms of sales[22]). Mass privatisation comes down to handing

over the ownership of state enterprises to the citizens. This was accomplished by giving vouchers to every citizen. Citizens could buy shares in privatised companies with the vouchers but in practice, they gave them to voucher companies in exchange of shares in these companies. Instead of the state, a few voucher companies became the owners of the privatised enterprises. The pro's of this privatisation form is that it guarantees a fast transfer of a large part of the state property to private hands. It ensures a wide spread of the property among citizens and therefore the creation of a middle class. Last but not least, it appeared to be a popular method used by governments to stay in power and ensure social rest.

The positive effect of all this for foreign investors is that it speeds up private market development and the attitude towards private business; this is also beneficial for the upcoming foreign enterprises. Our opinion is that the mass privatisation may have fulfilled its political aim, but it certainly did not create a conscious middle class. Neither has it improved the market-oriented operation of the companies that were privatised with vouchers. In addition, it has halted the participation of foreign investors in those companies and it has stimulated asset stripping. The privatised companies were either managed by investment funds or by private owners, mostly without any management experience. Foreign interests in mass privatised companies expected a number of difficulties such as lack of basic information about the companies, a large number of distributed owners; inexperienced management; non-transparent financial accounts and uncertainties about claims from previous and restituted owners.

It is of interest to foreign investors to know that in some instance the companies' ownership after privatisation shows a quite complicated structure (see Figure 4-7).

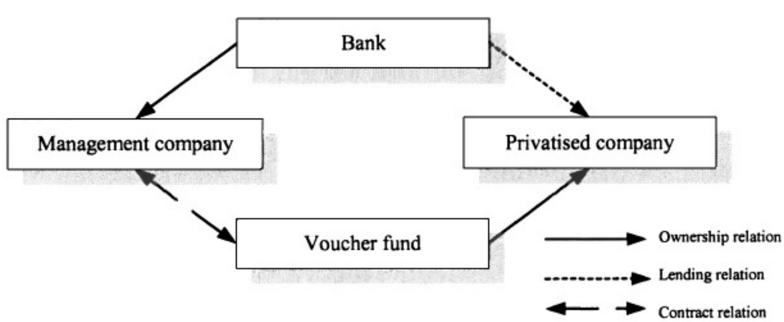


Figure 4-7. **Corporate ownership under voucher privatisation**

The dependence of the privatised firm on the bank – lender that at the same time is indirectly the owner of the enterprise, caused confusion and often conflicts of interest. The main issue a foreign investor may face in case

of take-over or joint venture with a firm within such ownership construction is the share price. It has been observed that the share prices of companies owned indirectly by banks have risen faster than those of other companies. This dual role of banks can be also seen in Germany and Japan for instance. It can have a positive effect on the companies owned. The study of the World Bank has shown that “the ownership by bank-controlled funds encourages restructuring in the Czech Republic”.[23]

The other popular form that all countries have applied is the cash privatisation. This form has been primarily used to attract foreign investors. Direct offers of state owned enterprises to a strategic partner have been practised mostly in Hungary, Estonia and to a lesser extent in Poland. Especially encouraging for foreign investors was the privatisation process in Hungary where foreign investments had already a tradition, where investors were welcome and in most cases the negotiations were held with the company’s management. Many large joint ventures were established in the beginning of the 1990s. The process halted after some public dissatisfaction concerning the fact that Hungarian citizens did not get equal opportunities.

Open bids were also widely used as cash privatisation. Open bids were prolonged and often non-transparent. Foreign investors were unable to obtain reliable information about the companies. Mafia participation and corruption has been closely associated with the selection process. In addition, the selling bodies were defining often quite restrictive conditions such as maintaining the number of workers for a period of time as much as 5 years, preserving the business for some years (non-restructuring clauses). This all has negatively influenced the eagerness of foreign investors to participate in privatisation. Even such methods like “debt-for-equity-swap” payments (e.g. ZUNK and Brady bonds used in Bulgaria) could hardly contribute to bringing more foreign investors to the country.

Despite the pitfalls of the privatisation process, it did have a direct link to the FDI inflow to CEE. The EBRD is of the opinion that the early start of the privatisation process in Hungary largely explains the fact that 85 percent of the FDI inflows in 1993-1995 came from privatisation proceeds. In 1995 about 60 percent of FDI in the Czech Republic came from privatisation.[24] The correlation coefficient between FDI and privatisation revenues per capita for the period of transition is found to be 0.72.[25] Most of the CEE countries have registered large privatisation deals in the last two years of the past century mainly in the banking sector and some public utilities.

The privatisation only gives investment opportunities when it offers a suitable local company. In many cases the status of the company for sale is not attractive. The attractiveness is a combination of its financial state and its potential competitive power. A classification of CEE companies is suggested

(Figure 4-8) that defines four types of enterprises and their attractiveness for Western companies.[26]

Many companies in CEE could be regarded insolvent according to Western definitions. However, the insolvency of an East European company

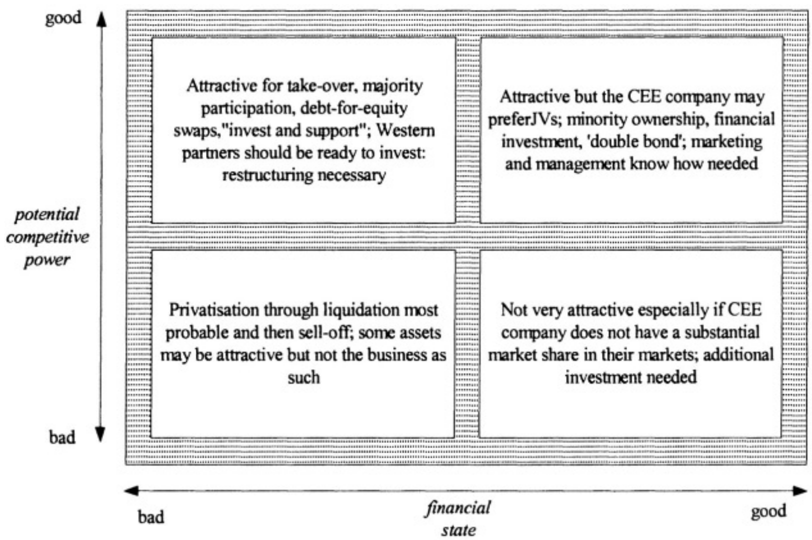


Figure 4-8. Classification of CEE companies

might not be based on its performance. It might be a result of the changes in the price structure, in the exchange rates, in the interest rates and the credit procedures.

Some enterprises have accumulated huge debts because of uncompleted construction that started years ago under very different circumstances. Some companies' debt came from new technologies and renovations of assets carried out just before the changes. Bad debt/equity ratios were not always a consequence of a company's decision. They reflected very often the investment structure of the state under the centrally planned system. The share of the companies not able to service their debt immediately after the changes has been as large as 60 percent in Romania and Bulgaria, 47 percent in Poland, 36 percent in Slovakia, 32 percent in Hungary, 29 percent in the Czech Republic and 22 percent in Slovenia. In only three years (1992-1995) the countries from Central Europe made immense progress achieving reduction of the bad loan ratio to 6 percent in the Czech Republic, 16 percent in Hungary, 17 percent in Slovakia and 20 percent in Poland.[27]

It is difficult to compare the competitive position of CEE companies with that of Western companies mainly because of the limited market they have been operating in before the changes. In addition, their driving forces were

not the market and the customers but the state plan. Many Central and East European companies possess a relatively high business competence but even then they were not designed to establish competitive positions in the market. Nevertheless, the market share in the local market established local brands; international contacts and modern technical know-how can provide basic conditions to improve the competitive potential of the local companies.

There is not much left for privatisation in CEE with the exception of some banks, utility companies and some enterprises with a monopoly status. At the same time the price that the countries may get for these state assets can be a substantial part of total FDI in the region. FDI in Poland for instance was boosted in 2000 by the sale of a 35 percent stake in the telecommunication operator to France Telecom for US$ 4.3 billion and stakes in two electric power generators for US$ 0.1 billion. In the Slovak Republic the government sold 51 percent of its national telecommunication company to Deutsche Telecom for US$ 0.9 billion; this accounted for 1/3 of the country's total FDI for 2000.[28]

It will be a challenge for the countries to compete for investors from now on and most of all to realise that after the privatisation deals are over, the only substantial form that brings large amounts of FDI are greenfield operations. In addition, the post-privatisation period will make already privatised companies or newly established private companies available for strategic partnerships with foreign investors. Joint ventures and takeovers aiming at assets and market share consolidation will prevail.

One of the major concerns for the foreign investors as well as for the governments of the CEE countries is how the process of wealth creation is going to develop. The major privatisations have nearly been concluded. The focus must shift to the encouragement of small and medium enterprises (SMEs) especially those that create high value.

4.4 Business environment

4.4.1 Private sector development

Policy liberalisation and the introduction of new laws and regulations to support the transition to a market economy in the CEE countries have changed the business environment in just few years. The first sign of this was the rapid emergence of a private sector. In 1999 the private sector was already contributing more than 60 percent of the countries' GDP (see Table 4-4). The increase of the private sector in the CEE economies has been 5 to 6 fold for the past decade. Most of the newly emerged private enterprises were small (fewer than 50 employees) firms. In 2002 small companies accounted

for more than 50 percent of employment (e.g. the average for the EU) in countries as the Czech Republic, Hungary, Lithuania and Poland.[29] With this contribution to employment the newly established companies can be considered an engine of economic growth.

Table 4-4. Private sector contribution to the GDP in selected CEE countries (in %)

Country	1990	1994	1999
Central European counties and Baltic states	11	50	68
Czech Republic	12	65	80
Hungary	18	55	80
Romania	17	40	60

Source: The World Bank (2002)

Small companies were representing more than 90 percent of all companies in the CEE countries by the end of the past decade. Although their number was high, their productivity was lower than similar companies in the EU. Nevertheless, the fact that the labour productivity in small newly established companies was higher than that in old companies had a positive effect on the overall business development. The Business Environment and Enterprise Performance Survey carried out jointly by the EBRD and the World Bank in 1999 finds that new enterprises outperformed old companies also in sales, exports and investment.[30]

In order to achieve higher benefits from the SMEs there are three areas in which CEE countries still face challenges:

- The encouragement of citizens towards forms of entrepreneurship that create added value and consequently more wealth;
- Introduce and maintain a fiscal and incentives regime that will make the establishment and the development of SMEs easier;
- Create conditions and develop attitudes that encourage foreign SMEs to establish themselves in CEE. At present there is a general feeling that “foreign investor” means being big.

The rapid growth of the small and medium private business in CEE offers opportunities to multinationals in two main directions:

- Good potentials to develop a domestic suppliers chain;
- Availability of local trade and distribution partners.

4.4.2 Business and investment climate

Another achievement of the change process in CEE is the introduction of a quite liberal and modern legal and regulatory environment for doing business in general and for foreign investments in particular. All CEE countries introduced (to name but a few): new company laws, bankruptcy

(insolvency) laws, banking and financial institutions laws, regulations of capital markets, pledge laws, competition laws. All new laws and regulations have been improved a number of times during the past decade to account for experience as well as negotiation pressure of the international financial institutions. Lately company laws have been amended in many of the Central European countries in order to conform more closely to the third EC Company Law Directive (e.g. Poland).

In terms of extensiveness and effectiveness of commercial law, Bulgaria, Estonia, Hungary, Romania and Slovenia are leading among the CEE countries. While commercial legal rules are reasonably clear for the rest of the countries, administration or judicial support of the law is often inadequate or inconsistent, creating a degree of uncertainly.

Estonia, Hungary and Poland lead in implementation of new financial laws and regulations. Hungary and Poland show the highest effectiveness of introducing them. In terms of effectiveness these two countries are followed by the Slovak Republic, Slovenia and Estonia. In the last group of countries, although legal rules governing financial markets are reasonably clear, regulatory and supervisory support of the law may be inconsistent.[31]

Text box 4-1. Incentives in the Czech Republic

- Act on Investment incentives (the first version adopted in 1998, then revised in 2000): tax relief (up to 10 years), job creation grants, training grants, provision of low cost building, land, and other infrastructure;
- Duty free import of machinery;
- National Programme "Support of the Development of Industrial Zones": grants to municipalities, transfer of land to municipalities for discount prices;
- Supplier Development National Programme: upgrading Czech potential suppliers and bringing them together with foreign investors;
- National Support Programme for Strategic Services: subsidies to investors in strategic services such as customer care centres, ICT solution centres, high tech repair centres, etc.
- National Support programme for Creation and Enhancement of Technology Centres: subsidies to investors in centres with innovation activities (with practical implementation; not fundamental research);
- Support from local governments: job creation grants and training and re-training grants;
- Incentives of the Ministry of Regional Development: in case of investments in priority regions especially aiming at job creation.

The main element of the Czech government's development strategy is focused on support of selected strategic greenfield sites (industrial zones) in all regions of the Czech Republic. Over CZK 723 million in government funds has been used since 1999 to develop more than 50 sites which can be ready for potential investors within a minimal period of time and in which local authorities now offer land to manufacturing investors at a significantly reduced cost. By 2001, the country's foreign investment agency, CzechInvest, had a database containing 180 sites, spread evenly across the country.

Foreign investment laws and regulations also define the business climate for the foreign companies in CEE. It is a well known fact that incentives and favourable investment regimes do not matter much for the motivation of companies' cross border investments. All CEE counties have introduced liberal foreign investment regimes that are comparable to those in the developed countries. In fact countries like Bulgaria and Hungary did have such laws and regulations before the transition period, yet attracting quite different levels of FDI.

The Czech Republic, a country that was quite late in introducing special laws and regulations concerning foreign investors, is an example that special incentives do play a role. It is very much the Act on Investment Incentives that gave the boost to the number and size of the inward investments in the last years of the past decade, especially after 1998 (see Text box 4-1).

Text box 4-2. Incentive schemes in Poland

In May 2002 incentives to both foreign and local companies:

- A subsidy determined as a percentage of the value of a new investment, but not exceeding 50 percent if the maximum amount of public assistance provided for a given location;
- A subsidy not exceeding the value of € 4 000 per job for the creation of new employment;
- A subsidy of up to € 1 150 per employee for the training of the workers hired;
- Assistance to the host communities in the creation of improvement of the physical infrastructure to support investment made by the investor.

Requirements to the investor:

- Te value of the investment is at least € 10 million;
- The value of the new investment is at least € 500 000, results in the modernisation and development of existing businesses maintains at least 100 jobs (or 50 jobs if the investment is made in priority area) for at least 5 years;
- At least 20 new jobs are created for at least 5 years;
- Involves technological innovation;
- Introduces modern, environmentally friendly technologies.

Similar effects have been achieved in the Slovak Republic where as of 2000 the new incentive programme has attracted a substantial amount of FDI. The new incentives, which should apply mainly to underdeveloped regions (a requirement of the EU), increase the tax holiday to 10 years (comparable to the neighbouring countries) and provide for grants for job creation and retraining. In addition, they allow zero import duty on some machinery. The Polish incentives scheme that was revised in 2002 (see Text box 4-2) will also play a positive role. As the EU becomes stricter on incentives schemes, it will be difficult for the smaller countries of CEE to catch up.

4.5 Consequences for foreign investors

The transition of the CEE countries towards a free market economy offers new economic conditions for foreign partners but at the same time it is accompanied by consequences for the business that are to be taken into account while investing there. For some investors they might be a threat, for others an opportunity. We will list some of the most important consequences and discuss their possible influence (see Table 4-5).

Table 4-5. Consequences of the transition process for the business

Consequences of the transition process	Threat	Opportunity
Stagnation of the national markets Insolvency of the traditional consumers	For companies producing capital goods and commodities which are not of primary need and have relatively high prices	For companies in food and light industry, agriculture, partly building industry which can maintain relatively low prices and develop distribution channels
Increase of the prices on consumer goods	For companies with high cost structure and which value chain is very much influenced by their suppliers	For companies with an effective cost structure and relatively stable value chain; for companies in primary needs productions (food and light industry)
Traditional markets are becoming more demanding in terms of quality of the products	For companies with low quality, old products, low innovation rate and low diversification; for companies in businesses with a long life cycle	For companies with high quality, advanced products on international level; for companies in light and other consumer goods industries
Distraction of the traditional network of suppliers and distributors	For companies which production is very much dependent on suppliers and/or distributors within the CEE counties	For companies which bring into or are able to build up quickly an appropriate suppliers/distributors network
Increased unemployment	For companies which openly announce their policies towards cuts of labour force	For companies which are employing an additional workforce and a motivating human resource management
Newly emerging and often changing economic rules	For companies which can not bare certain financial risk in the starting period; for short term profit oriented companies	For companies with long term strategies, oriented towards the local market and with financial abilities

5. SPECIFIC FEATURES OF CEE AS AN INVESTMENT AREA

It is very important for Western investors to think of CEE as a region that has its comparative advantages and disadvantages that have to be weighted in order to design a certain investment strategy. Although each country in CEE has its own specific characteristics, the region as such has a number of common features that will be listed bellow.

– *High specialisation but low efficiency*

CEE countries were forced to specialise in particular industrial areas under the agreements made within CMEA before 1989. As a result, most of the countries developed huge capacities in sectors such as chemical, machine building, steel and electronics industries. These capacities were serving primarily the market of CMEA countries in general and the former Soviet Union in particular. Companies in these sectors were vertically bound to each other. As a consequence of market liberalisation and the disconnection from traditional markets, the companies in these sectors suffer from lack of "economy of scale" effect, lack of markets, large debts. This made them unattractive for foreign investors. At the same time, some of these companies might offer reasonable production facilities, well qualified and experienced workers and Western like engineering staff. The developments in the last years have shown that the best CEE companies in the sectors discussed above have already been taken over by Western companies (e.g. Czech Skoda, Hungarian Tungsram, Polish Polam Pila).

– *Low labour costs but low productivity*

Low labour costs are often pointed as a primary advantage of CEE countries. Equally important is the productivity. CEE did approach the transition period with a relatively low labour productivity compared to the developed countries.

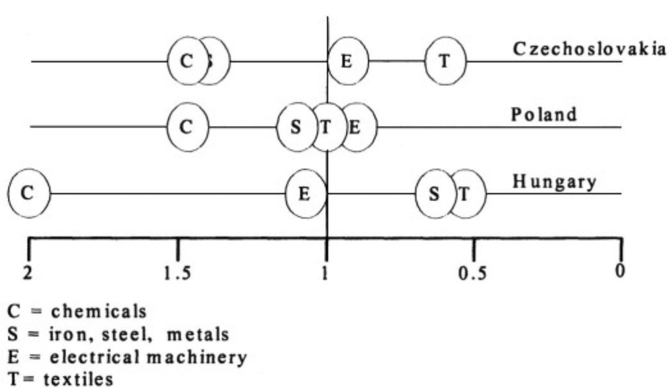


Figure 4-9. Relative sector productivities in various countries in 1987 (productivity = added value per employee; 1 = industrial average)

Countries such as the Czech Republic, Hungary and Poland had productivities around the industry average in sectors as electrical machinery, textiles and metals (see Figure 4-9[32]). In 1987 the value added per person employed in Czechoslovakia, Hungary and Poland was 10 times higher than it was in India and 5 times higher than in China and Indonesia. Productivity

was approximately at the level of Taiwan, Korea, Mexico and Portugal. The value added per person employed in each of these three countries was on average 3 to 4.5 times lower than in the EU member states.

After a major swing down of the productivity levels in all CEE countries after 1989, a recovery could be observed around 1998 – 1999. Slovenia reached 71 percent of the EU average of labour productivity, the Czech Republic and Hungary – 58 percent surpassing Portugal. Romania and Bulgaria achieved the lowest levels of CEE, around 30 percent of the EU average.[33] Leading CEE countries outperform Asian countries and show figures similar to those of Latin American countries (see Figure 4-10).

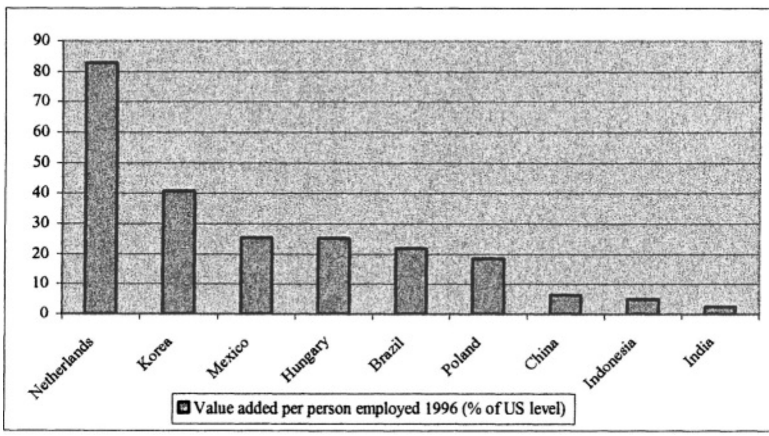


Figure 4-10. Labour productivity in 1996[34]

In 1990 the average monthly wage in US$ was 157.5 in Bulgaria, 182.6 in the Czech Republic, 212.8 in Hungary, 138.6 in Romania, 178.7 in Slovakia and 900.2 in Slovenia. In all CEE countries the wages went down after 1990 until about 1993-1994. In Bulgaria and Romania they never reached the level of 1990. The average growth of wages was the highest in Lithuania (3 times), Estonia (2.5 times) and Latvia (2.1 times). The wages in the Czech Republic and Poland doubled by the end of 1990s. The wage growth in Hungary and Slovakia was 1.5.[35]

A survey carried out by the EBRD and reported in the Transition Report 2000, finds out that:

a) The lowest productivity gaps between the productivity of the parent company of the foreign investor and the CEE subsidiary are in the countries of Central Europe; the highest in Bulgaria and Romania;
b) The productivity gaps are similarly distributed across unskilled and skilled labour;

c) CEE still maintains a considerable cost advantage over Western Europe when labour costs are combined with productivity.[36]

The combination of low direct labour costs and low labour productivity could diminish the total labour cost advantage unless productivity grows faster than wages. This is the case in most CEE countries. Another question is how long the price of the CEE workforce will stay low. Some forecasts predict[37] a period of 5 to 10 years and beyond. In our opinion the labour cost advantage will most probably stay longer in labour intensive industries such as textile and leather, ready made clothes, tobacco, chemical and metallurgical industries and food processing.

The labour cost advantage can be sustained by measures influencing productivity. The low productivity in CEE companies is mainly caused by lack of upgrading activities for the workers, inefficient labour organisation, counter-productive labour attitudes and practices, and inadequate management systems, including logistics and total quality control. Western companies that design and implement such measures in their Eastern European affiliates have the opportunity to extend the lifetime of the labour cost advantage.

– *Vertically organised and highly centralised companies*

Certainly the predominant functional and highly centralised organisational forms in CEE companies do not stimulate their market orientation and diversification. Very often this is a great concern for Western companies that intend to take over CEE companies. The attraction of CEE companies usually lies with their core businesses. In addition, there might be a number of side activities with very low efficiency. Taking over such a company means starting an immediate restructuring process that mainly proceeds through selling the loss making parts of the company (see the case of Sara Lee/DE). In some cases this might be a long lasting process because of the social sensitiveness of the restructuring. Some restructuring processes require completely different organisational formulae that destroy the dominance of the vertical dependence of the company's components. In this process one should not loose the functional expertise of employees, which is one of the advantages of the functional corporate structures. The transition towards decentralised organisational forms in CEE companies will have to be accompanied by a process of change, directed primarily to their human capital. Without realising this fact Western partners may enter into conflicts with the employees and the local management staff.

– *European culture and education but no commercial attitude*

Not only size and demand potentials of the CEE markets are important for Western investors but the social characteristics of the customers there are

important as well. By social characteristics we mean personal life styles, working values, education and consumer's behaviour. In this respect, CEE markets differ significantly from those of developing countries. Traditionally, CEE carries values that are closer to the West European ones. It all means that the social adaptation of the Western investors as well as the consumers' perception of Western like products would be easier and quicker in CEE than in many other countries. The high percentage of university graduates in CEE and the fast implementation of Western European types of training programmes will contribute to this. Association agreements and memberships of CEE countries to a number of European and international institutions will smoothen not only the economic but also the social differences.

At the same time, market oriented attitudes and business loyalty are values that have to be established not only amongst managers but also amongst workers in CEE. Only when Western companies start doing business with these countries, they realise that the change process of business values might take longer than expected.

> *"The people just don't understand a market economy." "They (people) must first change their attitude towards work, they think retrospectively." "You are tied to the available labour. You have to teach them new concepts and to assume responsibilities."*[38]

The business, especially financial concepts, together with the commercial awareness also differ from the Western concepts.

> *"The people have lived under the communist system for 40 years, the whole system of business management is underdeveloped."*
>
> *"In the old system there were a lot of planners and economists but no action planners."*
>
> *"They all expect a fast profit then comes the reality and no one can understand it. In terms of financial modelling they are way behind, they have no feeling for market trends and were never concerned with market values."*[39]

6. INVESTMENT DETERMINANTS OF CEE AS AN INVESTMENT AREA

The analysis of the macro-, micro- and specific characteristics of Central and Eastern Europe as an investment area allow for conclusions with respect to the most important investment determinants. Below we provide short description of these determinants and we briefly indicate their possible influence on investors' decision-making.

6.1 Determinants with a positive influence

– *Market size and potential*

This determinant is the main reason for companies to invest in CEE. A market with millions of consumers who are eager to buy Western goods is the main attraction. Though the products may not yet be affordable for every consumer, the mere potential is enough to pull companies into the investment process. Though in many cases the customers can also be serviced via exports, many companies feel that an investment is a logical and natural extension of their activities. The 'spin off of these investments is in general included in this determinant; these are investments that have been made by suppliers that follow their clients into CEE.

– *Economic climate*

The economic climate is to a certain extent related with market size; or rather market potential and market opportunities. But while market size mostly reflects the disposable or expected disposable income for the country or region as a whole, the economic climate comprises all aspects of the economy. The economic climate can have a positive influence on investment if growth is stable and structural, if the local currency is stable, if constrains for private business are limited, if basic legal regulations for doing business are in place. The availability of special incentives to stimulate business and foreign investment is essential in most cases. The extent and the expected speed of transition of CEE to market economies is of particular importance.

– *Political climate*

The political climate is determined by several factors, of which the level of political stability and the willingness or the capability of politicians to transform the centralised economy into a market oriented one, are the most important. The level of importance of this factor in the decision-making process is in some cases influenced by the determinant *geographic proximity.*

– *Geographic location and proximity*

The nearer the market, the more information is available, the fewer are the uncertainties and there are more possibilities for lobbying. In this respect the continental European companies are in a favourable position than the UK, the US or the Japanese companies. Geographic proximity is generally not a major factor, though in some cases it influences the investment decision. German and Austrian companies (not major players in the world investment process), perceive investments in CEE very much as an extension of domestic activities. Another aspect of the geographic attractiveness is that some CEE countries are well placed for trade in other countries or regions: e.g. former Soviet Union (CIS) or Middle East.

– *Historical links*

This basically means that companies from a certain country are more apt to invest in countries that share some history or have links from the past. Historical links are not regarded as a very important factor in the FDI decision-making process, but in some cases, they have influenced the decision. The fact that Austrian companies invest more than their fair share in Hungary as do French companies in Romania, proves this to a certain point.

– *Industry specialisation*

Western companies are often interested in industries that used to be core industries before the transition. Examples of such types of industries are the machine building, electrical machinery and light industries in the Czech Republic and Hungary where German, Austrian, Dutch companies have shown their interest. Italian companies have found the textile industry in Bulgaria attractive for its high specialisation in the sector. German tour operators are in Bulgaria for the same reason. The pulp and paper industry in Poland attracted foreign companies from the same branch.

– *Skills and cost of labour*

Low cost of labour can be an important determinant with a short-term effect. This is always looked upon in combination with skills and productivity. Based on the earlier analysis in this Chapter, the labour skills and cost determinant can give an investment advantage for another 10 years to go.

– *Fiscal regime (e.g. taxes)*

The fiscal regime is of little importance. An explanation for this can be the wide range of possibilities that international companies have in optimising taxes. Tax incentives (e.g. tax holiday) can be attractive in a short run. This might be one of the reasons to divert investors from one country to another (e.g. recent investment of PSA Peugeot-Citroen in the Slovak Republic for which Poland and the Czech Republic were also competing).

– *Investment incentives of CEE or Western governments/International institutions*

Investment incentives are not generally viewed upon as an important factor but they are often regarded in the investment decision process as a bonus. The experience of the incentive schemes introduced in the Czech Republic, Poland and Slovakia in the late 1990s shows that the FDI inflow has increased as a consequence of that. Such schemes mainly benefit large investors. Dutch SMEs argued that though they were acquainted with the programmes, they felt that the application procedure was too complicated while on the other hand companies stated that thanks to a subvention, they carried out a feasibility study that may lead to an investment.[40] Western governments and International Institutions often provide financial support to Western companies to enter CEE. Examples are: the EC Joop Programme that stimulates the establishment of East-West joint ventures, the EBRD and IFC (International Financial

Corporation) equity participation activities; the Dutch B2B (business to business) programme.

6.2 Determinants with a negative influence

– *Bureaucracy (red tape)*

Simple requests to the authorities can sometimes become lengthy negotiations, due to:

a) Difficulties in finding the true decision makers and reluctance on the part of the decision makers to take responsibility;
b) Frequent changes of individuals in authority that lead to timetable setbacks;
c) Inconsistency in views between decision makers and frequent changes in policy and direction;
d) The often overwhelming system of former central planning with its lengthy and complex permit and approval procedures.

– *Legislation*

Problems can also occur in the field of legislation. A lack of legislation or the inadequacy or ambiguity of key legislation especially occurs in the fields of taxation, accounting, bankruptcy, repatriation of profit, property and ownership rights. This leads to uncertainty and thus to a hesitation to invest. This uncertainty is only enlarged by the persistent amendments that are made to the existing framework. As explained earlier, the process in transition has positively influenced the legislative basis of the CEE economies. The process of accession will further neutralise the negative influence of this determinant.

– *Economic climate*

Negative economic/financial factors that hinder investment can be numerous. To name but few: high inflation or even a threat for hyperinflation (e.g. the case of Bulgaria and Romania in mid-1990s); currency instability; frequent changes in tariffs or difficulties on the supply side in general; import/export restrictions; ever-changing regulations concerning foreign investment, etc.

– *Business infrastructure*

Infrastructural factors that hinder business in general are unreliable telecommunications and distribution system, an insufficiently developed financial sector; often inadequate physical infrastructure (e.g. roads, rail transport), underdeveloped logistics systems.

– *Political climate*

The political instability in some CEE countries (e.g. the Slovak Republic under Meciar) during past decade has led to a deviation of investments to countries with a more stable political climate. The extent of importance

seems to be higher for countries that are in geographical respect further away from the investor. The negative influence of this determinant in the ten CEE accession countries is almost not present any more.

– *Fiscal regime*

Transparency and fiscal discipline are still insufficiently present in CEE. Taxes can be numerous and can add to a high share of the company's income. There is a high pressure on all accession countries to improve their fiscal systems. In addition, all CEE countries have recently introduced or are on the way to introduce substantially lower corporate taxes. As a result, the negative influence of this determinant will be diminished.

– *Cultural considerations*

Differences in culture can lead to problems in negotiations with authorities or employees. The most important cultural differences lie in the level of commercial awareness, the work ethics, insufficient free enterprise culture, often expressed hostility to foreign investment, language and cultural traditions.

7. CONCLUSIONS

The features of the change process in Central and Eastern Europe define to a large extent the framework conditions for investment. The achievements of CEE in their transition to free market systems and democracy allow for the following conclusions:

- Since the economic and political changes the markets of Central and Eastern Europe opened up for Western investors offering high demand and long-term growth potentials. Most of the foreign companies that have invested in the region have a positive view on its future attractiveness. The institutions dealing with country risk analyses and the international financial institutions consider the process of transition far reaching.
- CEE economies show stable economic growth, unsaturated consumers' demand and an increase of purchasing power. It is forecasted that these characteristics will remain valid for at least some 5-10 years to come. These growth factors alone, placed against the matured markets of Western Europe, make the region attractive for new investments and further expansion of the existing investments.
- The privatisation of state owned enterprises was certainly a new and unique opportunity for foreign companies with an interest to invest in CEE. Nevertheless, the privatisation was and is only one of the channels to take over or to buy shares in a local company. Most of the countries provide opportunities for other forms of foreign investments.

The choice depends very much on the features of the specific privatisation programme and on the availability of a suitable local partner. Very often the state of the art of the local company might require substantial restructuring which might overweight business expectations. In other cases, Western investors might benefit from the existing manufacturing facilities and often satisfactory technical conditions. There are still privatisation opportunities in the region. The privatisation of public utilities such as telecommunication, water, gas and electricity, is on its way since 2000. The CEE states hold controlling stakes in some banks, insurance companies and in some companies with a national interest (e.g. beer producers in the Czech Republic, tobacco companies in Bulgaria, refineries, large hotel chains in Hungary, etc.). In addition, countries such as Bulgaria, Romania and the Slovak Republic that were late with cash privatisation may still offer attractive opportunities. After the privatisation of the public utilities, the infrastructure sector may follow: the potentials are huge especially in the CEE countries with strategic location from a logistics point of view (e.g. central European countries – way to ex-Soviet Republics and Bulgaria – way to the Middle East).

- Although the attractiveness of CEE from a market point of view is predominant, low cost production and skilled labour can be added to the short-term attractiveness of the region. These advantages will slowly fade away as CEE countries move towards EU integration. Nonetheless, the region promises to stay low cost production base for about at least another decade. The productivity grows faster than the wages and this makes the labour unit costs attractive for foreign investors. The relatively skilled labour, especially in engineering, as well as the high quality of education, gives CEE an additional advantage.
- The geographical location of the region does not play an important role when compared with equal investment opportunities. Nevertheless, it is one of the priority areas for West European companies. The European Commission and the United Nations Conference on Trade and Development (UNCTAD) pointed out already in 1996 that EU businesses had been diverted from Asia by opportunities closer home, such as successful enlargements of the EU and changes in CEE.[41]

NOTES

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[1] *Assessing investment opportunities in Central and Eastern Europe,* OECD, 1994
[2] The market size of China surpasses that of CEECs and the CIS taken together

[3] This opinion was expressed by companies interviewed under a study carried out by OECD in 1994, Assessing investment opportunities in economies in transition, OECD, 1994

[4] All figures in this paragraph are UNCTAD data

[5] The most improving economies of 1994 defined on the basis of percentage change in predicted economic performance between 1993 and 1994 of the top 100 counties in the economic performance poll, Euromoney, September 1993

[6] *Transition Report,* EBRD, 1999, p. 123

[7] Data from EIM: 7th Observatory for European SMEs

[8] Based on EBRD data

[9] Djarova. J., W. A. A. Jansen, *Economic transition in Central and Eastern Europe,* in: Djarova. J., W. A. A. Jansen, The Change: Dutch business experience in supporting Central and Eastern Europe, Delwel, The Hague, 1996

[10] *EBRD transition report* 1995

[11] *Economic Bulletinfor Europe,* Vol. 47, 1995

[12] *Transition Report Update,* EBRD, May 2002, p. 3

[13] Enlargement 2004: introduction to accession on www.ecdel.org

[14] *Transition Report Update,* EBRD, May 2002, p. 7

[15] *World Investment Report 2002: Transnational corporations and export competitiveness,* UN, 2002, p. 68

[16] The 16 countries are the ten discussed in this book with the addition of Albania, Belarus, Croatia, Moldova, TFYR Macedonia, Ukraine

[17] EBRD transition reports

[18] Calculation made according to the transition report EBRD, 1999. The particular indicators of progress in transition (large-scale privatisation, small-scale privatisation, governance & enterprise restructuring, price liberalisation, trade & foreign exchange system, competition policy, banking reform & interest rate liberalisation, securities markets & non – bank financial institution) scaled by the EBRD are averaged.

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[28] *Transition Report Update,* April 2001, EBRD, p. 23

[29] *Transition: The first ten years, Analysis and lessons fro Eastern Europe and the former Soviet Union,* The World Bank, Washington D. C., 2002, p. xviii

[30] *Transition Report,* EBRD, 1999

[31] Ibid, pp. 44-47

[32] Adapted from: Pitt-Watson, D., S. Frazer, *Eastern Europe: Opportunity or Illusion?,* Braxton Associates, 1991

[33] Eurostat data

[34] Data from the Groningen Growth and Development Centre

[35] Data adapted from International Labour Organisation, KILM 2001-2002

[36] Adapted from: *How do foreign investors assess the quality of labour in transition economies? Results from postal survey,* Produced by the Office of the Chief Economist at the EBRD, London, 2001

[37] Havlik, P., *Exchange rates, competitiveness and labour costs in Central and Eastern Europe.* WIIW, No 231, October 1996; Barell, R. D. Holland in: *Foreign direct investment and enterprise restructuring in Central Europe,* Economies in Transition, Volume 8 (2), 2000, 477-507

[38] Opinion of companies interviewed within the survey of OECD carried out in 1994

[39] Ibid

[40] Working together in Eastern Europe, Business Development Committee, COB SER, 1992

[41] *Europe's business record in Asia under fire,* Financial Times, 20 March 1996

Chapter 5

Cross-Border Investment Model

1. INTRODUCTION

This chapter introduces the Cross-Border Investment Model (CBIM) that is derived from the study of a number of cases of cross-border investments to Central and Eastern Europe. The elements of the model as well as its validity are discussed in section 2. The logic of the CBIM is then explained in detail following each element of the model as well as the match between the elements.

Sections 3 and 4 discuss modern views on company's global strategies and their particular application to Central and Eastern Europe as an investment area. Company's investment objectives towards CEE are specified in section 5 while their match with investment determinants are explained in section 6. Different investment modes are distinguished in section 7. The way they are matched with investment forms is a subject of section 8. The chapter concludes with a typology of company's investment decisions (section 9).

The Cross-Border Investment Model has served as a basis to conduct case studies some of which are presented in Chapters 6–10 of this book.

2. CROSS-BORDER INVESTMENT MODEL

As any other strategic decision, investing in Central and Eastern Europe has its specific logic the core of which is to match company's desires to develop itself with the opportunities in foreign countries. As any other

strategic decision such cross-border investment decisions differ from company to company. Such differences come from the company's investment objectives and its experiences in cross-border investments. It also derives from the different risk margins that companies are willing to bear in cross-border deals. Naturally, large multinationals have an advantage both in experience and risk. Therefore, they can be observed to be the first foreign investors in CEE markets. Small and medium sized enterprises (SMEs) need more time for feasibility studies and risk evaluation. They need to rely on the real-life experience accumulated by larger companies. Once multinationals have paved the way into a country, SMEs follow with more confidence. This is the reason why this book focuses on the experience of multinationals in investing in Central and Eastern Europe.

5-

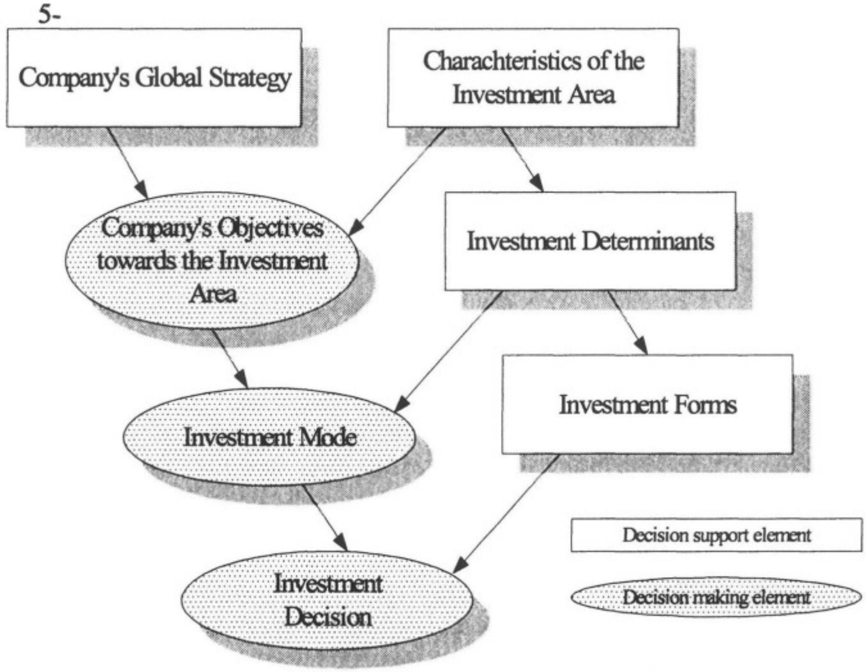

Figure 5-1. **Cross-Border Investment Model**

The Cross-Border Investment Model (CBIM) distinguishes decision-making and decision support elements (see Figure 5-1). Decision-making goes in stages; its elements are areas where the company discusses alternatives and proposes decisions. The model accounts for three such decision stages if the company's global strategy is taken as an input to the process. Decision support elements supply the decision-making process with information. The establishment of a "company's global strategy" is seen as a

decision-making element in a process outside the CBIM model. The decisions support elements are perceived by the CBIM as given externalities that cannot be influenced by decision-making within this model.

The CBIM defines four *decision-support elements:*

- Company's global strategy: we will discuss such decisions in section 3 of this Chapter;
- Characteristics of the investments area. We discussed this in general terms in Chapter 2 and more specifically for Central and Eastern Europe in Chapter 4;
- Investment determinants specifying the framework of attractiveness of the investment area. This was discussed in Chapter 3, particularly section 6;
- Possible forms of investment are discussed in sections 7 and 8 of this Chapter.

Three *decision-making elements* are derived from the information supplied by the decision-support elements. These are:

- Company's strategic objectives towards the investment area. The theory of such decisions will be given in section 4 of this Chapter, the actual objectives towards CEE are the subject of section 5;
- Investment mode, to be discussed in section 7 of this Chapter;
- Investment decision, a typology of such decisions will be discussed in section 9 of this Chapter.

The strategic objectives towards the investment area are derived from the company's global strategy and the characteristics of the investment area; this is the first decision-making point. The objectives towards the investment area define its concrete dimensions towards a particular investment area taking into account the characteristics of this area as expressed in investment determinants. Matching the investment objectives for the area with the investment determinants of that area yields what we call an investment mode, i.e. the investment attitude that the company will take. This is the second decision-making point and it will be discussed in section 6. Finally, the investment mode together with the possible investment forms define the directions of the final investment decision that is the third decision-making point, to be discussed in section 9.

The CBIM has been checked with a number of companies-foreign investors, some of which multinationals. In this book, the model is applied to Central and Eastern Europe as an investment area.

As to the validity of the CBIM, it is interesting to observe that while the processes of decision-making in different companies deliver differences in the decisions made, the decision-making processes themselves are very similar. Decision makers may not always realise that they follow logic close to what the CBIM suggests. In some cases investment decision-making is

more structured than in other cases. Companies may use external advice to achieve a better understanding of certain elements of the decision-making process, mainly on the decision support side. The necessary expertise can also be found within company's departments that are responsible for analyses, units that are responsible for the region concerned or for foreign affiliates in general.

In many cases companies use a structured approach towards the procurement of necessary background information. Feasibility studies are often mentioned as an analytical tool to obtain and process this information. Companies apply specific methods of categorisation of investment areas. ING Group for instance defines "non-presence" and "presence" countries on the basis of four characteristics of a country: it is considered an emerging market; its financial markets are clearly imperfect; multinationals are interested in the country; there are attractive one-off investment opportunities. Part of the feasibility study is the cost-benefit analysis that matches the choice of the entry product portfolio and the margins expected in the specific country. In the case of ING, the high margins expected were related to the underdeveloped banking system in the CEE region.

Text box 5-1. ABN AMRO

The Netherlands based bank ABN AMRO applies a special methodology to analyse markets. Important elements of the checklist for emerging markets are:

a) Political environment - change process, characteristics of the change; attitude to change in the country especially of the government and the main political forces; political system and the work of the parliament, stability, etc. A score from 0 to 5, where 5 is the maximum, is given to each of the political indicators in order to weight the political risk.

b) Social-economic environment - basic indicators are used on the basis of the World Bank classification (telephones, hospital beds, etc.). A score from 0 to 3, where 3 is the maximum, is given to the indicators in order to score the social economic risk.

c) Economic situation evaluated in three main groups of indicators: macroeconomic indicators - GDP, sectoral development, inflation, fiscal and monetary policy; financial ratios - liquidation, debt/export, etc.; industrial development - privatisation, restructuring, management skills, etc.

Information and different views on countries are collected from the IMF, Euromoney, the World Bank, The Netherlands Bank. Information may also come from other institutions and Bank's clients. Local sources are also used but they have the intention to be too optimistic and their reliability is sometimes doubtful.

For its feasibility studies, Unilever uses a checklist developed by the company itself. Although the checklist is updated when applied to a new investment area, in preparing the checklist for CEE the experience in Latin America and Asia was extensively used. A checklist is one of the methods to

list the investment determinants that the company should pay special attention to. The checklist is company specific, reflecting the field of business and the nature of internationalisation the company pursues (see the experience of ABN AMRO in Text box 5-1).

Companies use external sources of information to support the feasibility study. Such sources are reports issued by the EIU[1], the World Bank, OECD, EBRD, the IMF and private institutions. The experience of lawyers, accounting consultants and banking analysts can be of help. The contribution of local experts may be important if delivered objectively. Unilever for instance uses its national organisations if present. When working with local consultants, Unilever bears in mind that there can be difficulties in the common understanding of what information is needed while there may be different ways of thinking and quality of work.

The results of the desk research are often checked widely in the company for the reason that other units may have relevant additional experience. Experience concerning consumer behaviour from all over the world, the perception of the products, the ways of marketing and distribution can give valuable inputs to issues such as market approach, sales, distribution and marketing strategy towards the new investment area. A fact-finding mission usually follows desk research. The fact-finding mission may already be an acquisition mission (e.g. Unilever, ING Group, Sara Lee/DE).

In most cases the green light for proceeding with investment decision-making is given by the corporate management body. This is the level where strategies towards new investment areas are matched with the global strategy of the company as well as with the general framework strategy for the region (CEE in this case). The final decision-making may lie with the lower levels of the management, the national companies for instance, as is the case of Sara Lee/DE.

All companies go through preparatory activities (e.g. feasibility studies, desk research, fact finding mission, talks to embassies, etc.) in order to analyse the status of the decision-support elements: the characteristics of the new investment area, the value of the investment determinants and the investment forms that are possible there.

Companies with European origin take less time for their preparation work for CEE than the firms from the USA and Japan. The explanation is that European companies know the region better, being location- and culture-wise closer to the region, some of them already present there.

3. COMPANY'S GLOBAL STRATEGIES

Before discussing corporate global strategies as such, we would like to briefly discuss some terminology. There is a number of definitions for companies that are involved in international business. There is no common understanding of the interpretation of all these definitions. The most successful classification is offered by UNCTAD that has introduced a set of definitions and terms in the field of FDI through its Investment Reports. Definitions of the World Bank, IMF, OECD and UNCTAD slowly tend to converge (as discussed in the Annex). It seems difficult, especially for researchers, to adopt the same definitions and their studies still offer new interpretations. Since particular definitions are not that important for our further discussions, we do not have the intention to introduce new or revised ones. In broad lines we will adopt the definition of UNCTAD of *transnational corporations* (TNCs) as "firms comprising parent enterprises and their foreign affiliates". A foreign affiliate is an "enterprise in which an investor, who is a resident of another economy, owns a stake that permits a lasting interest in the management of that enterprise (an equity stake of at least 10 percent for an incorporated enterprise or its equivalent for an unincorporated enterprise)".[2] The term transnational is equal to UNCTAD's term multinational: "those companies that are involved in cross border business with long lasting interest". These can also be called international companies although "international" has a broader meaning, as companies involved in cross-border trade are also international.

While the definitions above reflect the business activities of the companies, some other definitions rather indicate their strategies. That is how the theory of international business accommodates terms as multidomestic or multilocal and global for instance. Yip (2003) calls a truly global company one that "does business not only in both the Eastern and Western hemispheres but also in both Northern and Southern ones". He claims: "the global company does not need to be everywhere, but it has the capacity to go everywhere, deploy any assets, and access any resources, and it maximises profits on global basis".[3] The difference in strategy between global and multilocal companies is that the former applies an integrated approach across countries; the latter has an approach related to the specifics of each country.

Whatever the definitions, one thing is clear and this is that opinions on how global or how local a multinational should be differ widely. The slogan of Theodore Levitt "Think global, act local" tries to find the compromise in the middle stipulating that companies should plan and organise on a global scale but adapt to local needs. While George Yip argues that the debate on globalisation has ended and that there is no other way but to globalise, the

executive director of Coca-Cola in 1999 announced that their business is fundamentally local. While Christopher Lorenz identifies the "1990s phenomenon: the migration of multinationals away from geographic structures towards global ones"[4], Michael Skapinker claims that "the world's most successful companies remain clearly identified with their countries of origin"[5]. For instance the merger of "equals", Daimler-Benz and Chrysler, is in fact a German takeover, in terms of its nature as well as of its management dominance. Ruigrok and van Tulder (1995) show that of the first thirty listed US companies only five had a foreigner on their executive board.[6] On average, multinationals originating from small countries have a higher degree of internationalisation in every functional area of management. Mark Scott (2001)[7] found that of the top 100 economies in the world, 46 are companies, not countries, with a turnover growing twice the average pace of a large nation. In many instances the decisions governments take on these companies have a major influence on the nation. Scott thinks there is no such thing as a global company. There is only the multilocal company that serves distinct local markets.

Relocation of production and even of high added value activities for the company such as product design and development, branding or engineering, does not necessary mean a move towards globalisation. It rather has to do with pursuing a competitive advantage. Geographic specifics and intangible assets such as knowledge and skills that define part of companies' competitive advantages may often be difficult to transfer or can only be transferred to a particular location. Culture matters too, especially in mergers and acquisitions. British prefer American partners for their positive attitude, French prefer French, German prefer German, Dutch prefer German and American for their professional approach. Most European companies would not merge with a Japanese partner because of the incompatible language. Swedish companies have difficulties with Italian – never know where you stand. Dutch and Spanish partners do not understand much of each other.[8]

While we would disagree with Harold James (2001) that globalisation fails, we would also not fully agree with George Yip that the multinational model is now in question. We would rather stay with Lewitt's "Think global, act local" as we believe that the truth is in-between the two extreme views. We also support the vision of Percy Barnevik, former ABB CEO, that "execution, not strategy per se, is primarily what differentiates the winners from the losers"[9].

In this book we use the term 'global strategy' to reflect that:

g) Multinational companies usually do not ignore any new signal from any new market: in principle, every country matters;
h) Multinational companies usually have a coherent view on their activities worldwide;

i) Multinational companies compete on the basis of their total world wide performance;
j) Multinational companies develop competitive advantages on the basis of their ability to operate worldwide;
k) Multinational companies distribute and minimise risks using their worldwide presence and expansion;
l) Multinational companies expand worldwide in order to achieve higher returns on equity and to maintain or improve their competitive positions.

A strategy can be called a "global strategy" whether it is focusing on the specifics and the needs of local markets or whether it is emphasising the development of standard business activities with a broad international application.

The "global strategy" should not be mistaken with the organisational structure and the decision-making structure of the company. The history of multinationals knows a few swings between decentralised and centralised structures; decentralised being the ones that shift more responsibilities to the foreign affiliates; centralised being the structures that leave most of the decisions at headquarters' level. Centralised structures are often related to difficult times for the company. The cases of this book (Chapters 6–10) tell us that many international firms are in the process of finding the right balance between the centralised and the decentralised approaches.

Global strategies offer distinct advantages. Yip (2003) summarises the benefits for the potential globalisation as: cost reduction; improved quality of products and programmes; enhanced customer preference; and increased competitive leverage.

Classic works of researchers of international business such as the ones by Prahalad and Hamel (1989[10]), Hout, Porter and Rudden (1982[11]), Prahalad and Doz (1997), Bartlett and Ghoshal (1989, 1995), and Porter (1990) discuss the advantages of globalisation and strategies to go global. To summarise, the main advantages of going global are:

1. Getting closer to foreign customers and suppliers, as well as local knowledge and skills
2. Organising an optimal international production base
3. Achieving an efficient value chain beyond single locations/markets
4. Achieving higher defensive capabilities against competitors locally
5. Achieving higher chances for consolidation of assets
6. Achieving higher economy of scale and economy of scope effects.

FDI is a clear indicator for the globalisation of business activities. In 2001 FDI was four times higher than in 1990. In 2001 there were more than 65 000 multinationals with 850 000 foreign affiliates all over the world.

They employed 54 million employees (against 24 million in 1990). Their sales were twice as high as world exports. Foreign affiliates account for 1/10 of world GDP and 1/3 of world exports.[12] Two worldwide developments drive the multinationals to become even more global. These are:

1. Policy liberalisation within and between economic blocks and countries. This opens national markets and makes the international markets less fragmented.
2. Rapid technological change that presses for search of tacit knowledge anywhere in the world and for sharing the risks and costs of innovation on a global basis.

The two trends drive up the competition. This requires an integrated strategy that accounts simultaneously for: extended market reach, cost and production optimisation, consolidated asset growth and higher returns. The new developments observed among multinationals are:

– Intensity of integration both at regional and global level;
– Emphasis on the efficiency of the system as a whole.

The investigation of UNCTAD[13] shows that the critical elements for successful international production are:

a) Governance (equity, non-equity based): need of internal and external control (e.g. of brand name, marketing).
b) Global value chain: value chains becoming fragmented as business functions become more diversified and specialised; more focus on knowledge intensive, less tangible functions in the value chain such as product definition, R&D, marketing, managerial services, branding. Contract manufacturing grows rapidly.
c) Geographic configuration: there is a new trend towards integration of production on ever larger geographical scale; supply chains have extended to new areas of the globe; while distance might matter less for many transactions (improved information and communication technologies), proximity to markets remains important for certain products.

The share of the value of cross-border mergers and acquisitions in total world FDI increased from about 1/10 in the 1980s to 1/3 at the end of 1990s.[14] Driven by the privatisation processes in Central and Eastern Europe, this ratio has become even higher (e.g. 2/5 by 2000), growing rapidly after 1995. About 75 percent of all acquisitions are 100 percent takeovers of domestic companies. In terms of value, approximately 70 percent of the cross-border mergers and acquisitions are horizontal, meaning between companies from the same branch of industry. They represent 50 percent of the total in terms of number. There is a global trend of an increasing number of vertical mergers and acquisitions; these can be forward (with buyers or trade channels) or backward (with suppliers). While in the late 1980s foreign

investors were striving for short-term results, mainly financial gains; at present they have more strategic economic interests.

The analyses of trends and characteristics of FDI as provided in Chapters 1 and 2 clearly show that emerging markets attract foreign investors. The rapid spread of corporate activities from developed countries into emerging markets underlines the globalisation of companies. In view of the current global trends, there are new opportunities for the emerging markets. These are:

- To become part of the international production system;
- To enter technology intensive and export oriented activities they would not enter alone.

Table 5-1. Share of foreign affiliates in the exports (in %)[15]

Country	Year	All industries	Manufacturing
Czech Republic	1995		15
	1998		47
Estonia	1995		26
	2000	60	35
Hungary	1995	58	52
	1999	80	86
Poland	1998	48	35
	2000	56	52
Romania	2000	21	
Slovenia	1994		21
	1999	26	33
Portugal	1996	23	21
	1999	17	21
Ireland	1991		74
	1999		90
Austria	1993	23	14
	1999	26	15
Malaysia	1985	26	18
	1995	45	49
Chile	1995	16	
	2000	28	

Central and Eastern Europe has gained clearly its share in the globalisation of business (3.7 percent of world FDI in 2003[16]). The figures and the analysis provided in Chapter 2 support this. Another figure that demonstrates the growing participation of CEE countries in the globalisation process is the share of foreign affiliates in their national export. For instance, Hungary, Poland and the Czech Republic are among the 20 economies achieving the highest gains in export market share for the period 1985-2000 (see Table 5-1).

CEE contributes to the world trend of assets and markets concentration in industries such as commercial banking, automobile industry, telecommunications as well as food, beverages and tobacco where foreign

investments are prevailing (see also the cases in this book). Multinationals entered the region mainly through greenfield operations and less through acquisitions. Foreign investors showed a preference towards horizontal rather than vertical acquisitions although this has been caused to a large extent by the privatisation process. During the past decade the strategies of the multinationals towards Central and Eastern Europe have matured. During the first years of the 1990s many multinationals assumed that CEE offers a new market for their old products or an extended market for their existing products. Horizontal expansion was therefore more in their mind than vertical expansion. Low-knowledge and low technology-intensive and therefore less risky activities were preferred by many of the foreign investors. With this set of mind[17] one can also expect limited success in emerging markets. Success in emerging markets often requires "innovation and resource shifts on such a scale that life within the multinationals themselves will inevitably be transformed. In short, as MNCs (multinationals) achieve success in those markets, they will also bring corporate imperialism to an end."[18]

The fear of failure when entering a new market has a historic explanation: companies did face difficulties when expanding abroad. Therefore they search for effective strategies that can reduce the risk of failure in international expansion. This search brings them often to what they know the best: current products, current technologies and business models of operation. It seems that in most of the cases when firms expand into international markets, the first question they approach is whether to continue in the same product areas or to diversify. A decision to diversify can reflect a coherent international strategy of the parent company. A study by Bane and Neubauer (1981) found that subsidiaries often failed when undertaking unrelated diversification outside their home countries. Diversification is a critical variable that can affect the performance and survival of the foreign affiliates.

A firm's entry strategy, i.e. establishing a new subsidiary, creating a joint venture or acquiring an existing company, reflects an important decision for multinationals. The few studies on this subject have shown that the choice of an appropriate entry strategy is a critical determinant of the likely success of foreign operations. Wilson (1980), using the database of Harvard's Multinational Enterprise Project, concluded that subsidiaries, newly established by the parent company, were less likely to be divested than those acquired from other firms.[19]

First-time investors and firms that have considerable previous experience may differ in their motives for international expansion, the implementation of expansion strategies and the effectiveness of these strategies.

Knowledge of and experience in the target market are critical to international expansion, firms being more likely to invest in places where they or their competitors in the same industry have invested before.

In his study of US computer and pharmaceutical industries over a 15 years period, Li concludes that diversification increases the exit hazard of foreign affiliates; acquisitions and joint ventures are less risky than greenfield operations; "firms benefit from experience in international operations and learning from other investors".[20]

Buckley concludes that the "international competitiveness of a firm is dependent on the selection of an appropriate set of foreign market servicing strategies as well as the effective management of the chosen market servicing modes".[21] International companies cannot just transfer their existing business models across borders. The cross border success depends to a large extent on how a company prepares itself to enter a new market, how serious it analyses the characteristics of the new investment area and how it adapts the current business strategy to the new investment location. All this requires a tailor made approach to each individual market.

Whatever the global strategy of a company, it needs to be specifically defined when applied to a specific investment area. Applied to CEE as an investment area, the global intentions of the company will be translated into specific strategies and objectives.

4. SPECIFIC FOREIGN INVESTMENT STRATEGIES

Before going to the company's investment objectives towards the investment area, let us discuss some specific foreign investment strategies. For reasons of simplicity, we will classify companies' global strategies in two large groups:

1. *"Go global":* strategies leading companies to a position of a global market player, and
2. *"Invest abroad":* strategies that utilise pure investment opportunities for the companies.

Companies operating in a global and oligopolistic market primarily pursue the strategies from the first group. There is always a dilemma whether to diversify at home or to expand abroad. Many studies show that the first option has a smaller success rate than the second one. Partly this is because cross-border options offer more opportunities in expanding in core businesses. The latter adds as a rule more value than diversifying into related activities. In addition, cross-border expansion might bring new competitive advantages or might strengthen existing advantages on a global scale. For

companies operating in a global and oligopolistic market, to be a global player is very much a "must" strategy. In realising this strategy one can stay a multidomestic company or turn global. Multidomestic companies gain from the better match between production and local consumer needs. Global companies gain from the comparative advantages of nations and experience a sustained "economy of scale" effect.

Strategies aimed at realising investment opportunities abroad, are mainly performed by companies with a strong position in their home markets which they expect to remain their primary markets. Therefore the successful or unsuccessful realisation of these strategies would not harm the position of the company. These companies would invest in a certain country if they estimate the risk to be small and if they find a profitable business opportunity.

Within the two groups of strategies, "go global" and "invest abroad", companies very often pursue two concrete intentions (see Figure 5-2):

1. Expand or strengthen global market share,

or/and

2. Reduce costs or achieve higher efficiency.

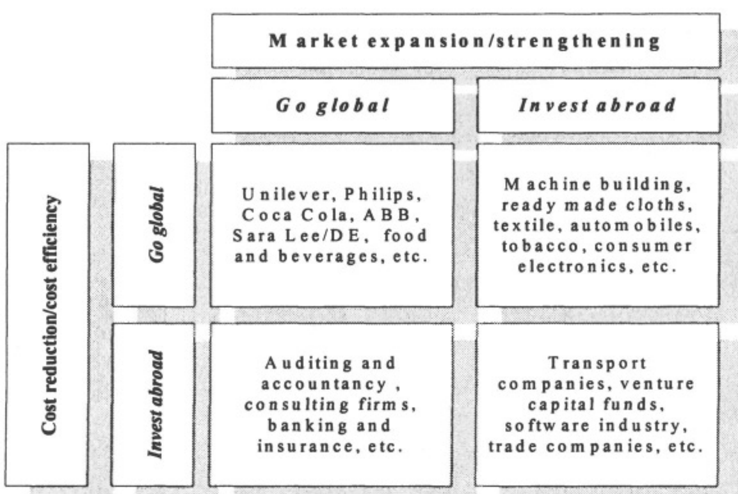

Figure 5-2. Matching of specific strategies

Applying only a cost reduction strategy results mainly in transferring production from a more expensive area to a less expensive one. In this case it is necessary to find a reliable partner in terms of quality and loyalty that can act as a subcontractor. Sometimes, the cost reduction strategy can be realised by building up or taking over local factories. In both cases the domestic market does not influence the cross-border decision. Primarily important is

the legal framework that defines the investment regime in the country. Cost reduction objectives often concern export-oriented investments where the right combination of production factors (e.g. labour, manufacturing facilities, location and resources) play a role.

Pursuing a market strategy requires investigations on consumer needs, prices, competitors, consumer demand, distribution channels, possible suppliers and legal framework of the country. This strategy usually implies an ownership involvement in domestic companies or establishing of a subsidiary. The process might take a substantial time and in most cases it has a long-term effect.

Global companies often realise market strategies in combination with cost reduction strategies. Companies might search for an investment opportunity abroad to establish a "cheap satellite" - a supplier company with lower production costs, e.g. by using old generation technologies. Some companies might be eager to only explore the option of a new investment area that they estimate more attractive than the investment options at home.

Especially the market-oriented strategies, sometimes combined with cost reduction strategies, give companies a global strategic position. The global strategic position is closely related to the increase of the competitive power of the company. We define three crucial aspects of the global strategic position. These are:

1. Consolidation of assets and markets (quantitative growth): makes you larger, protects you from hostile takeovers, spreads your risk; you need to follow your competitors and clients;
2. Be first *on* the market: benefit from low competitiveness; possibilities to dominate the establishments of the business rules; often high margins; profit from one-off investment opportunity;
3. *Restructuring* on a regional or global base: relocation of production to more efficient locations; repositioning of R&D to locations with high and efficient knowledge and skills; achieve optimal efficiency in the entire value chain of your business activity.

5. COMPANY'S INVESTMENT OBJECTIVES TOWARDS CEE

The first step in the decision making process concerning a cross-border investment is to establish the company's objectives towards a specific investment area. As we saw in Figure 5-1, this decision is based on the global strategy of the firm respectively the characteristics of the investment area, in our case, CEE. In Chapter 4 we discussed the characteristics of CEE

as an investment area and here we will just summarise what CEE is offering investors:

- Access to new markets and distribution channels with a lower level of competition than at home;
- Cost advantages in terms of cheap labour, raw materials, energy and services;
- Underutilised production capacities some of which are on an adequate technical level;
- Potential of highly qualified employees, especially technical employees;
- European like consumers' behaviour.

The specific strategies of Western companies attach specific investment objectives when the CEE "offers" are taken into account. We distinguish three groups of investment objectives (see Figure 5-3):

1. Market objectives
2. Cost reduction objectives
3. Pure financial objectives.

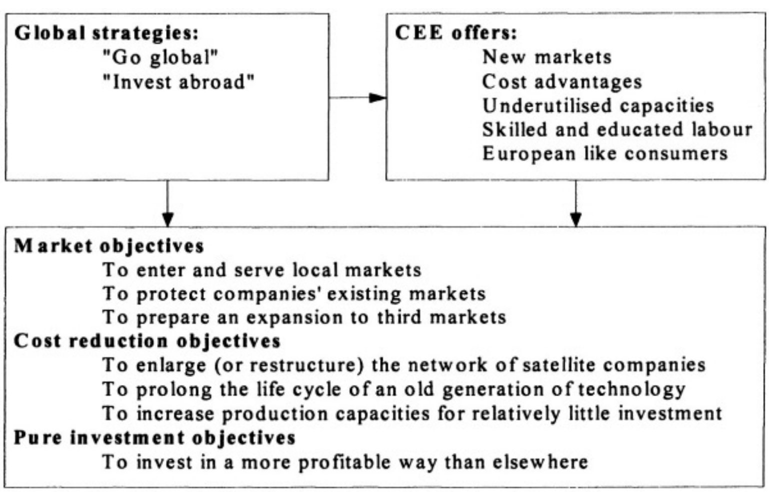

Figure 5-3. Three groups of investment objectives

It is important to bear in mind that we are considering these objectives within the frame of the existing business of Western companies.

5.1 Market objectives

5.1.1 To enter and to serve local markets

This particular objective intends to realise the expansion of the company's sales or/and production into the local markets of CEE countries. CEE offers a market of about 100 million people[22] (and in close proximity in the East a market of more than 200 million people), unsaturated demand and for the time being low levels of competition. All this explains the relatively low level of entrance barriers. Some companies chose simple trade of their goods using local distributors as their entrance strategy. Later, they develop their own distribution channels and move to local production. Other companies have a more aggressive approach by taking over a local producer or building up new production facilities.

For example, the Dutch multinational Philips is already present in almost all CEE countries by trade. Philips starts with a representative office and sells its products through existing shops. In some countries (e.g. Poland) it started immediately with production by taking over a local company, in this case light bulb manufacturer Polam Pila.

One important objective of companies producing consumer goods such as beer, food, drinks, personal care products, detergents, etc. is to develop existing or acquire local brands. Very representative in this respect are the cases of Unilever and Sara Lee/DE as discussed in the book. Another striking example is the eastward expansion of beer producers and chocolate companies where brand related objectives are vital for conquering the market.

For most of the ambitious brewers there are good opportunities in CEE as the beer consumption is much below the EU level. International beer companies typically start with purchasing local brewers in CEE. The next step is modernising them and introducing modern marketing expertise to strengthen the purchased local brands. Interbrew is an example of consolidation through acquisitions: it moved from **6th** place in the world in 1995 to **2nd** in 2000. Heineken combines buying local brewers and promoting its global brands such as Heineken and Amstel. For Heineken a brand name is the most important asset to buy. The craftsmanship is available in CEE and Heineken brings technology to give the beer consistent quality; in addition it brings added value in sales and marketing (see Text box 5-2).

Text box 5-2. The case of Heineken

The purchase of the Austrian based brewer BBAG by Heineken (the largest take over in Heineken's history) will result in dominance on the Polish market – more than 37% of total market share. SAB-Miller has 32%; Carlsberg 16%. The two make more than half the market share in Poland. They may consolidate the number of brewers and shut down some of them.

According to Anthony Ruys, Heineken's general director, the newly fused operations of Heineken and Brau Union will have market-leading positions in 8 of the 13 Central and Eastern European countries where they operate. This will lead to many small brewers losing their access to the market.[23]

5.1.2 To protect company's home markets

Western companies are given the opportunity to maintain some of their existing markets by applying a low price strategy and by selling an old generation product in a profitable manner. A good example is the Skoda car, produced in the Czech VW/Skoda plant that is sold in Western Europe for a relatively low price. To protect the company's existing markets (in this case Western Europe) can also mean to neutralise a potential exporter to these markets. In addition, the protection can be directed towards maintaining the quality of the exported goods. Therefore, the partners of Western companies in CEE often have sole distribution rights especially when it concerns their traditional markets (see Text box5-3).

Text box 5-3. The case of Philips

In 1991 Philips took a majority stake in Polam-Pila (Poland). It invested in Pila's 5 plants over US$ 250 million. 70% of all glass tubes broke, cracked or ended up faulty. Philips invested in a new glass furnace, in intensive training; strengthened the quality control. Two years later Philips Lightning Poland needed to produce 112 tubes for every 100 effective fluorescent lamps. This allowed for export to Philips sales organisation in the Netherlands. About 60% is exported to North America and the UK in addition to other CEE countries and Russia. Pila had experience to export to the West before the changes. In 1996 Philips bought 60% of the Polish company Pabianice (investment of US$ 70 million), a company specialised in bulbs for the car industry (GE and Osram were also bidding for the company). [24]

5.1.3 To prepare an expansion to new markets

CEE can be a "spring board" to third markets because of two main reasons. First of all, CEE countries have the potential of recovering the former economic relations within the region including ex-Soviet Union. Second, they offer manufacturing and labour capacities at lower prices, which is reflected in the price of the products. Third, they are close to the EU with definite perspectives for accession. As a result, foreign investors could

have the opportunity to enter third markets with a low price strategy combined with Western quality. For instance, VW/Skoda opened up new low price markets such as Greece and the rapidly expanding CEE markets. Such an approach is often adopted by Japanese companies. They mostly see Europe as one region and they chose locations from which they can serve the entire region. Japanese companies consider the Czech Republic and Slovakia as the second most attractive location for European production after the UK.[25] Matsushita Electric Industrial invested US$ 66 million to build a factory for the production of Panasonic televisions in the city of Plzen (Czech Republic) with the aim to serve a larger European market than just the Czech market.[26] Some American companies adopt strategies similar to the Japanese: looking at the region as part of Europe and having a pan-European approach.

In many cases a combination of the three market objectives can be observed. The experience of Western investors in CEE by mid-1990 for instance has shown the following:

- The share of export-oriented investments in CEE was about 70 percent: more than 50 percent of the export went back to the multinational itself; pure market oriented investment represented 20 percent; with the objective of relocation of production invested 7 percent of the companies.
- More than half of the investors followed their competitors (especially applicable to market-oriented investments).[27]

5.2 Cost reduction objectives

Three cost reduction objectives seem to be applied by Western companies in CEE. These are:

- To enlarge the network of satellite companies: spreading the risk, optimising the cost efficiency in the supply chain;
- To prolong the life cycle of an old technology/product: “cash cow” products can still be sold in immature markets; old (labour intensive) manufacturing technologies can be transferred to low cost locations and developing markets;
- To increase production capacities with low investments: obtain low price assets.

Cost reduction objectives were present in East-West business relations before the start of the changes in CEE. Co-production was the form that was often used to realise such objectives. This is one of the reasons why co-production was the number one form of East-West co-operation at that time. Western partners were gaining mainly cost advantages and CEE countries were finding co-production a means to adopt new products and to implement

new technologies. The CEE companies that were involved in co-operation with Western companies of that time were the most wanted enterprises for take over after the change (see Text box 5-4).

Cost-oriented investments, leading to transfer of production facilities abroad, are to a large degree contingent on the level and development of the domestic cost and burden factors relative to those of other locations. This concerns a large number of EU countries. For instance, cost and burden factors in Germany compare unfavourably to many other countries. Therefore, a high proportion of German investments may be connected to cost-motivated transfers of production facilities abroad. The CEE region experienced the most spectacular growth of German FDI in the 1990s. A large number of studies revealed that the overwhelming majority of German manufacturing FDI since mid-1980s was driven by market motives. Recent surveys show that cost factors have increased in companies' location decisions.[28]

Text box 5-4. The case of General Electric

General Electric (GE) purchased Hungarian Tungsram in 1990, immediately after the opening of the region. Tungsram was desired by the competitors of GE as well. Tungsram is the third oldest company in lighting; with about 8 percent of the European market prior to 1990; the 5th largest light source manufacturer in Europe and the 10th globally.

Hungary is at present GE's principal base in European manufacturing. The plant in the UK was closed. As of 1995 the European R&D facilities of GE Lighting were consolidated in Budapest.[29]

In many cases one can observe a combination of cost reduction and market objectives. The eastward expansion of ABB was driven by the intent to get closer to the markets anticipating new public assignments. At the same time, the cost efficiency objective has caused restructuring of the production units in the West (see Text box 5-5).

Text box 5-5. The case of ABB

ABB has built a network of 60 companies in the Eastern Europe region. Such an investment allowed the company to raise its profits and sales. Moreover, the countries concerned highly benefited by a contribution to the economic transformation. ABB's first acquisition (of Zamech, Poland's turbine manufacturer) was discussed already in 1988. This was followed by investments in Poland and the Czech Republic. ABB's plants now range from Poland to Kazakhstan. This move has helped ABB to secure lower-costs sources of components such as turbines and switchgear. ABB has controlled the financial risks by keeping the acquisition costs low. ABB respected the local technical competence but the upgrading of technologies was slow. Originally, ABB's strategy was that Poland could become the Taiwan of Europe, but later they saw potential in the Polish market as well.[30]

5.3 Pure financial objectives

Some companies with purely financial objectives find investment opportunities in CEE that are more attractive than elsewhere. Usually these investments offer high returns and can be cancelled by the investor any moment. In this case market and cost reduction objectives are not so important and it is not necessary that the investment be within the lines of the investor's business. Realising pure investment objectives in some of the investment modes, which will be discussed later, might appear attractive for exploring future possibilities of the investor to move to another group of strategic objectives. Small foreign investments in competitive CEE products and CEE companies with good chances in the international market might realise this competitive potential in a form attractive for the Western investor. Some small and not regular foreign investments in CEE within the scope of investors own business might be perceived as "finger on the pulse" approach.

6. MATCHING INVESTMENT OBJECTIVES WITH INVESTMENT DETERMINANTS

Once a company has established its investment objectives for a certain investment area, it has to select the most appropriate investment modes. These modes are derived from the area objectives respectively the investment determinants of the area or the country (Figure 5-1). If one compares CEE with other emerging markets on the basis of some main common determinants, the differences can be shortly summarised. Latin America is perceived in general as relatively low risk. At the same time, this region suffered from high inflation rates for decades. CEE stabilised much more rapidly showing a very healthy government attitude towards market reforms and maturity of macro-economic policy (see Unilever case). SMEs in CEE achieved a 50 percent contribution to the GDP in a relatively short time. In Latin America the control of the state over the economy was higher than in CEE for decades. East Asia scores high on macro-stabilisation, quality of labour, large developed markets; these indicators are similar to CEE's. One important difference is that CEE was (still is for a part) the only emerging market that had a pent up demand and pent up production capacities. In all other emerging markets one has to start with greenfield operations. In a pent up production it is the mentality (e.g. manufacturing, producing) that brings a fundamental advantage for CEE. Political stability,

market and democratic forces have developed in CEE in line with the West. The prospect of accession to the EU makes the region even more attractive to oversees foreign investors (e.g. entering CEE means entering the EU markets).

Investment objectives can be realised when there are appropriate investment determinants in place. Investment determinants are usually related to political, economic and social-cultural conditions for the business. The match between investment objectives and determinants towards CEE shows that market oriented investments look for conditions with a wider scope. Companies with cost reduction objectives only need a less developed business environment (see Table 5-2).

Below we propose the most likely match between company's investment objectives and investment determinants.

Table5-2. Matching investment objectives and determinants

Main determinants	**Market-oriented objectives**	**Cost reduction objectives**
Market size	✓	
Economical climate	✓	
Political climate	✓	✓
Geographic proximity	✓	✓
Historical/culture/business links	✓	
Industry specialisation	✓	✓
Low costs of labour		✓

a) With regards to the market

The sheer market size, measured by disposable income or other measures, is the most important determinant for companies that have the objective to enter a new market since those companies will always try to enter the largest, hence most potential, market first. Companies with cost reduction objectives do not necessarily need market size as long as they can export their manufactured products to their traditional (and possibly new) markets.

b) With regards to the economic climate

The economic climate is a very important determinant for market-oriented investments. Companies with pure cost reduction objectives (for instance outsourcing) are not that sensitive to the economic climate, since they aim at the use of local resources, not the local market.

c) With regards to the political climate

The political climate is important to any company independent of its investment objectives. The level of importance may vary. It rather depends on factors related to the company itself than on factors related to its objectives.

d) With regards to geographic proximity

The geographic proximity is relevant to companies with cost reduction objectives and market objectives. For industries for which timely delivery and transportation costs matter, the geographic proximity provides an advantage. Companies interested in market expansion start by covering adjacent countries (e.g. less monitoring costs; easier logistics of supply from home base; the case of German and Austrian companies in Central European countries). At the same time in case of choice, the size of the market is always predominant (e.g. many investors started from Poland).

e) With regards to historical/business links

While historic links may have a descriptive value for the stocks of investments in a certain country, whether they have a predictive value remains to be seen. Companies with market objectives find it easier to enter markets where they will meet customers with known to them behaviour. The statistics on FDI has shown that American and Japanese companies have more affinity to Latin American and Asian countries respectively (that are also closer geographically). The European firms invest easier in CEE.

f) With regards to industry specialisation

Companies with cost reduction objectives benefit from the positive value of this determinant in CEE: availability of skilled labour, availability of production base and key know-how. A market-oriented investment profits from specialisation in case of a take-over of local company in the same sector (horizontal take over).

g) *With regards to the low cost of the labour*

Especially companies with cost reduction objectives are interested in low labour costs. However, as mentioned before the low labour costs should be looked upon together with the productivity. Even then this is a short-term match.

7. INVESTMENT MODES

The definitions of investment modes of cross border investments are based on two criteria:

- Level of control, and
- Level of commitment.

The level of control is higher when the company enters the investment area alone than when it goes for partnership. The level of involvement varies between short-term and long-term commitment to the business activities in the investment area. The combination of the two criteria leads to several types of investment modes (see Figure 5-4).

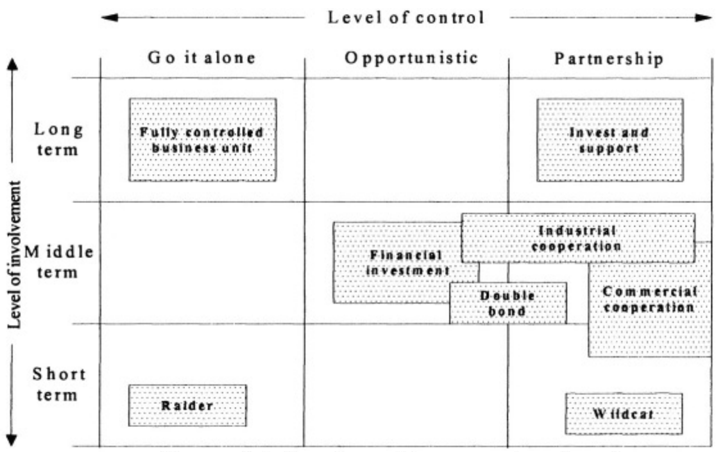

Figure 5-4. Typology of investment modes of companies

The highest involvement of Western companies in CEE can be realised trough production and/or sales subsidiaries in cases where companies apply a "*go it alone*" approach. A subsidiary can be established by using the following three so-called investment forms:

- Greenfield company;
- Take-over of a local company;
- Majority in a local company.

The main advantage of the Western company in establishing a foreign subsidiary is that the company has complete control over all primary business functions such as production, distribution, pricing, promotion, etc. It also allows the company to maintain control over the quality of products, innovation and human resource management. In the form of a subsidiary, the Western company can develop and adapt its investment plans easier. In the case of a take over or a majority ownership, the implication for the local partner is that he becomes a part of a larger network.

Greenfield operations are attractive for the following main reasons:

- The design of the factory is not limited by previous production facilities;
- The environmental liabilities are cleared;
- A wider choice of locations is available;
- There can be preferential offers by the state for locations in special industrial zones;
- No social burdens are inherited from the existing company;
- No internal organisational restructuring is required;

– Open selection of employees within newly developed labour conditions is often an advantage (see case on automobile industry in this book).

Takeovers and majority ownership in CEE are basically related to privatisation deals (also discussed in Chapter 4). There are cases where the foreign owner takes only a minority share of the privatised company but such cases are limited. In the case of a privatisation deal, the owner, the state, puts certain requirements towards the potential buyers. Usually these requirements concern additional investments to be made in modernising the company, lay off of employees to be limited and core activities to be preserved. Therefore, Western companies often have to pay first for the shares and second for the fulfilment of an investment programme. At the same time the companies for sale need restructuring in most of the cases that would mean another follow up investment anyway. Of course, one should take into account that many privatisation deals were a bargain for the Western buyers. A balanced decision is to be made which weighs the financial involvement of the Western partner and the follow-up obligations towards the privatised company.

The *"raider"* mode falls under the "go it alone" approach and it represents a hostile and short-term interest. In this case the foreign company takes over an East European company with the intention to sell it at a profit, either by reducing the personnel, by selling the company in parts, by stripping its assets or by combinations of these.

The involvement of the Western companies can also be high in cases when the "*partnership*" mode is applied. The main forms of "*partnership*" are commercial and industrial co-operation (e.g. licensing, franchising, outsourcing, delivery of plant and equipment, joint tendering or joint projects.) and joint ventures.

Joint ventures with a local company are preferred when one or more of the following factors are available:

- The local producer is experienced;
- The local partner knows the market better;
- The local company has a high share of the local market and/or owns a well known brand;
- The local company has a local and in cases an international network of suppliers and distributors;
- The local partner has a R&D potential;
- The operations can start immediately.

Joint ventures can be horizontally or vertically integrated with the main business activities of the Western partner. With the establishment of a horizontally integrated joint venture the Western partner pursues primarily an "expansion" strategy. This means that its intention is to enlarge the

existing core business activities in a profitable manner. With the establishment of a vertically integrated joint venture the Western partner pursues a "backward/forward integration" strategy. It enlarges the network of satellite companies. Most of the East-West joint ventures are horizontally integrated.

Other "partnership" investment modes are:

- The *"invest and support"* mode when the Western company takes a minority share in a local business. It brings in money, know-how and commercial contacts for the CEE company. It desires an income stream from the investment and it expects the values of the shares to increase. It does not intend to sell the shares in the short term.
- The *"wild cat"* investment mode comes as one of the ways for the Western partner to try out the business opportunities in CEE without involving much risk. It takes say 10 percent of the shares in a promising East European company and monitors its progress, 'see what happens'. At a later stage it may move to an "invest and support" mode or it may withdraw alternatively (e.g. EBRD equity investments).

Commercial co-operation comes when Western companies want to be present with their products on the CEE markets without heavy investments. Sometimes the commercial modes of entry are only the first step towards a new market: a higher involvement mode may follow. In other cases, commercial modes of entry may be sustained just for the reason of simple trade. Popular commercial co-operation modes are exporting, counter-trade and franchising. While CEE countries already knew exporting and counter-trade, franchising was non-existent. This entry mode did take an advantage of the favourable conditions in the region as a result of the transition to market economy and consequent increase of the small private business. Western companies often see franchising as an alternative to joint ventures. It provides access to the marker at the same time entailing less risk. If picked up by eager local entrepreneurs and if embedded in a favourable business environment, franchising is a very good alternative to joint ventures. Of course, this applies to a number of specific sectors such as food, auto dealers, auto rental, computer hardware/software, cosmetics, hotels, and petrol stations. The franchising formulas of McDonalds, Burger King and Pizza Hut in food, Yves Rocher and Oriflame in cosmetics, Herz and Avis (car rental), Novotel and Intercontinental (hotels) and many others turned out to be successful in CEE. They play an important role in improving the service sectors in the region.

There are some additional investment modes of a more opportunistic nature:

- The *"double bond"* mode consists of business cooperation supported by a small investment. The investment is not an objective by itself but a way to strengthen the commercial cooperation. It is applied when the foreign investor does not have an interest in investment as such but in protecting the co-operation between the partners. Therefore it is very similar to the industrial co-operation with the difference that here the Western partner takes a small share of the Eastern partner or even the two companies exchange minority shares between each other.
- If the Western partner brings in only money and it is not involved in the business, we recognise a *"financial investment"* mode. The interest of the Western company can be short-term as well as long-term but the investment usually takes the form of minority shares.

8. MATCHING INVESTMENT MODES WITH INVESTMENT FORMS

Companies' investment objectives are derived primarily from their strategies. Investment determinants reflect the characteristics of the investment area. The two combined – the second decision moment in the CBIM model - form a solid basis for the company to discuss and possibly decide on the most appropriate investment modes. The desired investment mode can only be undertaken if respective investment forms are available and realistic in the investment area under consideration. The investment mode, as chosen by the company, is reviewed against the possible investment forms in order to arrive at a concrete investment decision; this is the third and the last decision moment (see Figure 5-1).

Developments in CEE show that in the 1990s foreign companies moved from joint ventures to greenfield operations and takeovers due to intensive privatisation in the region. This trend mainly concerns companies from the EU. Japanese investors still respect the joint venture as an investment form that brings you closer to a market you do not know good enough.

Western companies often face the choice whether to establish a joint venture or to participate in the privatisation of the desired company. It is important to emphasis on the difference between the two choices (see Table 5-3). In the case of a joint venture, the partners contribute to the new equity in money or in kind. The usual case is that the CEE partner enters the joint venture with fixed assets and people, and the Western partner with money. Sometimes, the Western company might also bring technologies, equipment and know-how about markets. In this way the payment is only once which is very much an investment type of payment. In addition, a new equity is been established that gives more freedom of choice to the Western partner as to

the kind of labour to employ and which assets to include. The negotiations are to be carried out directly between the partners. The state (in case the Eastern partner is still state owned) has the right of a final check and approval of the deal. The latter takes time but in most cases it has a positive result. There is one particular risk involved in joint venture deals with CEE companies that are still state property. Sooner or later the company will be privatised which will have repercussions for the joint venture. The change of ownership might bring a risk of conflicting interests. Therefore, the most secure structure for a Western company to enter into a joint venture with an Eastern state owned partner is to have majority participation, as this will give decisive management rights to the Western partner. Usually the Western partner will have obtained an option on the remaining shares. In a further privatisation the Western company might be the buyer having in mind its experience with the Eastern partner.

If the Western company does not want to enter into a full ownership or a majority ownership structure, the construction of a subsidiary and an equity joint venture with a state owned enterprise is not to be preferred. Advisable then are the modes "invest and support" and "double bond". They assure a minority participation of the Western company in a privatising or privatised company with possibilities to move further to more binding constructions or to withdraw completely.

Table 5-3. "Joint venture/ownership" dilemma

Forms	Advantages	Disadvantages
Ownership through participation in a privatisation of a CEE company	Opportunity to learn more about the company Opportunity to negotiate the price and the conditions Follow-up control over the business	Negotiations with the state Double investment Buying the "bad" and the "good" part of the company Follow-up obligations towards the former owner
Joint venture deal with a CEE company	Negotiating with the partner Investing in kind Influencing the contribution of the CEE partner Decisive rights in selecting labour and management	Approval procedure by the state Expected privatisation of the CEE partner Conflict of interests possible with the CEE partner

The mode "invest and support" is suitable for companies in the same business where the support of the Western company can really improve the business of the CEE company and therefore its value.

The mode "double bond" is to be chosen when the foreign investor does not have an interest in investment as such but in protecting the co-operation between two partners. If the Western company is a significant buyer of the

products of the CEE company (which is often the case with the co-production and licensing) both partners are vulnerable and they may want to underline the relationship by a small investment.

The "wild cat" investment mode gives the Eastern European company badly needed money, while the Western partner prevents a competitor to take over the Eastern European partner. He also gains experience in the country, valuable for the future decision-making.

The mode "financial investment" can be beneficial if applied to perspective companies in Eastern Europe. In addition, some CEE companies that would like to stay alone on the market and to preserve their brand name and management control prefer this investment mode.

"Raiders" is an investment mode that one cannot advise and that can hardly be recognised at the initial phase of investment.

There is a close interaction between investment modes and investment forms. A fully controlled business unit can be realised either through a greenfield, by a take-over, or by a majority ownership in an existing company. The "invest and support" mode can be pursued by a minority participation in an existing company with promising financial results and with a future option to expand the ownership. The "double bond" is based on a protective construction of exchanged small shares between the West and the East European companies or on a minority participation in the Eastern partner. The "raider" approach ends up in a take over of an East European company with the future opportunities for further profitable sell. The "wild cat" as a try out strategy does not go beyond a very small ownership participation in an existing company and further than "invest and support" as a possible follow-up strategy. Minor in terms of shares is the participation of the "financial investment" mode and it is there where high returns might be expected. The industrial co-operation strategy can be realised in several forms among which joint ventures are the most popular ones. In addition, the forms of co-production and licensing will still be widespread and very often they can be found as an element of other than the co-operation forms.

The statistics available do not provide a full picture of the different forms of investments applied to CEE. Very often the type of investment agreement is unknown and the boundaries among different types are not clear enough in order to classify them. In addition, some forms, as discussed before, might be transformed after the agreement is been signed. Typical for instance is the transformation of joint ventures into wholly owned subsidiaries. The statistics as available by the mid-1990s, that is, before the privatisation gained speed, shows that about 25 percent of initial[31] and 23 percent of total[32] committed investment were accounted for by joint ventures against respectively 9 percent and 7 percent for fully foreign owned subsidiaries[33].

Takeovers accounted for only 3 percent of initial investment and much less for total investment.

A study carried out in 1996 among 1 222 foreign subsidiaries in the Czech Republic, Hungary, Poland, Romania and the Slovak Republic revealed that:

- The greenfield operations represented 48 percent of all investments, of which 25 percent were wholly owned by the foreign investors and 23 percent were joint ventures;
- The acquisitions were 52 percent of total investments, of which 24 were joint venture constructions, 13 were share acquisitions, 9 percent were asset acquisitions and 6 percent were equity increases.[34]

As of mid-1990s, when the privatisation gained a higher momentum, takeovers started to prevail over joint ventures and minority forms of ownership. Unfortunately, there are no detailed statistics to show the exact distribution of foreign investments by investment forms. One trend is clear though: despite the unprecedented wave of privatisation in CEE in the past decade, the greenfield operations have brought more FDI into the region than the takeovers. The value of cross border acquisitions into CEE reached US$ 10 billion (40% of total FDI in the region).[35] A substantial part of them was acquisitions due to privatisation. Smaller was the share of takeovers of local privately owned companies (e.g. especially in Hungary where the privatisation is nearly completed). With privatisation going to be complete in a few years and with the business laws developing in CEE, we foresee that more varieties of investment forms will come forward in the coming years.

9. TYPOLOGY OF INVESTMENT DECISIONS

We distinguish five major types of investment decisions towards Central and Eastern Europe:

1. Offensive
2. Defensive
3. Consolidative
4. Relocative
5. Opportune

The investment decisions are defined by the level of importance of the two main investment objectives for the company: the market objective and the cost objective (see Figure 5-5).

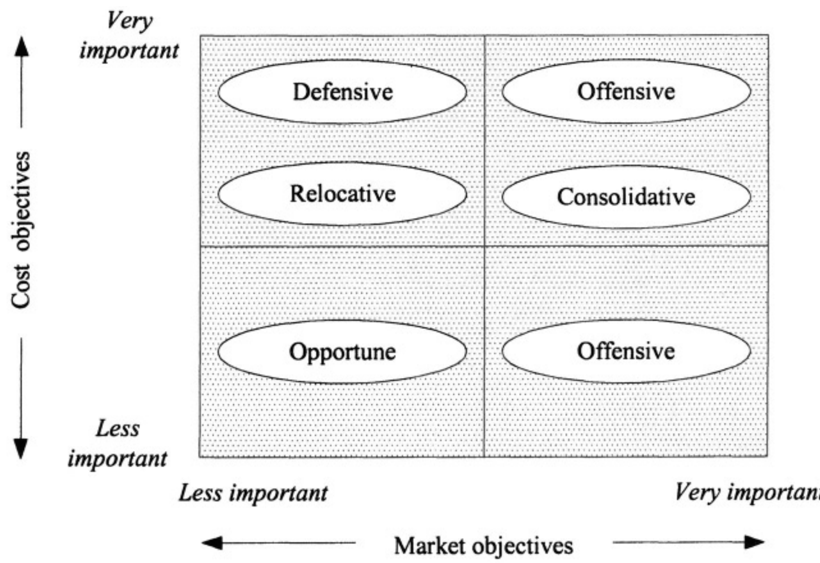

Figure 5-5. Typology of investment strategies

Offensive investment decisions are mainly aiming at market expansion: to enter and serve local markets and to expand to third markets. Such investments vary from about 1/3 to 3/5[36] of the total country's FDI, respectively for less advanced and more advanced CEE countries and depending on the size of the market. This figure includes activities related to sales and distribution that complements the exports from the EU to the CEE. The offensive investment decisions usually spread beyond the industry itself. Since sales, distribution and packaging are important for the fast expansion, such activities often become an integral part of the company's presence in the country (e.g. Coca Cola, Sara Lee/DE, automobile companies). In the line of argumentation comes the development of a network of local suppliers, an action that helps to achieve market tailored prices. Offensive investment decisions have a long-term strategic intent.

If the investment aims at protecting the company's existing markets, it does not result from an offensive type of decision. An example are the exports investment where the emphasis is placed on production cost reduction in general and on the availability of cheap skilled labour in particular. Investment decisions with such characteristics are classified as *defensive*. Defensive investment decisions can also be aiming at overcoming unfavourable business aspects (e.g. trade barriers) of the investment area.

Such investment decisions are often taken when the business and the market conditions in the home country do not provide enough growth opportunities. Examples are the cases of the car market and baby food in Western Europe. Countries like Germany have become less attractive for investments in the last years: high and rising labour costs, short working hours, high corporate and labour taxes and costs associated with the inflexible regulatory framework.[37] Defensive investment decisions are short term unless they are transformed into relocative later on.

Consolidates are the investment decisions that are driven by the urge to become larger (capitalisation). This protects (to a certain extent) from hostile takeovers, spreads the risk. Such investment decisions often result in market consolidation as well. The importance of the costs in this case stems from the need to act as quick as possible where one should have the necessary resources. The one-off-opportunities in CEE have opened the space in the region for consolidative investment decisions. Such are the cases of the banking companies and the brewing industry. Consolidative investment decisions are often horizontal (same branch of industry).

Relocative investment decisions towards Central and Eastern Europe are a sensible subject to discuss. There are no convincing figures that Western companies tend to relocate part of their activities to Central and Eastern Europe. At the same time, there are indications that this process has begun (see the case of automobile industry). A study of EBRD claims that about 20 percent of the investments aim at relocation.[38] Tüselmann (1999) states that the growth in German FDI to CEE presumed to be associated with the relocation of production facilities.[39] One third of German companies investing in CEE undertook a cost-motivated acquisition or establishment of production facilities. Many companies transferred lower value added and intermediate parts production.[40] Relocation, driven by cost efficiency, often results in reducing actual and potential domestic production and investment. Relocation, driven by supply chain optimisation, can have the same effect. In both cases, investment decisions may be short term depending on how long the cost advantage will hold. Relocation (or location) investment decisions are important for US companies and partly for Japanese companies that see Europe as one market. They often choose a location from which to serve the entire European market (e.g. Toyota, GE).

The relocation towards CEE is mostly observed in labour intensive industries, in commodity industries and lately in the industrial R&D sector. Eighty international companies in the automobile industry, electronics, Pharmaceuticals and computer technologies have open R&D units in Hungary.[41] IBM and ING are going to use Hungary as a base to serve European- or even worldwide. Philips considers relocating the production it has in Hungary to a country with even lower costs of labour. Hungary then

will start manufacturing high technology products. In certain advanced services Ericsson Hungary serves customers worldwide, says the manager St. Pehrson. Ericsson closed lately many product and research centres and the one in Hungary remained.[42] Honeywell Inc. intends to build a global design centre in the Czech city of Brno[43] being attracted by the recent government's strategy to promote FDI in high-tech industries and R&D activities.

Opportune are investment decisions that do not place much importance on neither the market nor the cost base of the investment area. These realise the "investing abroad" strategies and often take opportunistic investment modes.

10. CONCLUSIONS

Instead of conclusions we will quote the opinion of G. Schriber, Director Eastern Europe (in 1992), Du Pont de Nemours International, Geneva on company's decision-making towards Central and Eastern Europe:[44]

"In the past Du Pont did not consider Eastern Europe as a region to make major investments. This is changing and when we plan for a new European plant today we are beginning to compare the economics and general operation conditions between Western and Eastern Europe. Provided East European countries can offer sound laws, attractive economic conditions and a stable political climate some of our new plants could well be built in the East. Let me explain in general terms some of the factors that our specialists consider in selecting potential new sites for investment:

We must feel welcome, both nationally and locally.

The overall economic conditions in the host country must be attractive.

A sound infrastructure must be in place or about to be installed.

Quantitatively and qualitatively, adequate manpower resources must be available at lower cost than in Western Europe and the USA, Eventually, as productivity increases this difference will disappear.

The political climate must be positive, and laws governing investment and property ownership must be clear. There should be guarantees made by the host country and the US to protect investment.

A single government authority must be responsible for negotiating financial incentives and granting all permits.

There must be tax incentives. A ten-year tax holiday on profits is considered normal.

There must be investment grants – that is, financial contributions by the local authorities to help finance the project, in return for certain guarantees on the investor's part.

Du Pont aims to own 100 percent of the equity, but in certain circumstances may consider becoming a minority partner."

NOTES

[1] Economist Intelligence Unit
[2] This definition ca be read in any Investment Report of UNCTAD in its section “Definitions and Sources”
[3] Yip, G. S., *Total Global Strategy II,* Prentice Hall, New Jersey, 2003, p.7
[4] Lorenz, C., *Cross-border victory, national casualty,* in: Financial Times, May 6 1994
[5] Skapinker, M., *Worlds apart,* in Financial Times, March 4 2001
[6] Ruigrok, W., *Why nationality is still important,* in: Financial Times, 5 January 1996
[7] Scott, M. C., *How to build companies as strong as countries,* John Wiley and Sons, 2001
[8] Adapted from a study carried out by Sue Cartwright and Cary Cooper from the Manchester School of Management finalised in 1995; about 500 senior managers from 17 nationalities with international orientation interviewed
[9] In: *Global strategies: Insights from the world’s leading thinkers,* A Harvard Business Review Book, 1994, Preface
[10] Hamel G., C. K. Prahalad, *Strategic intent,* in: Global strategies: Insight from the world’s leading thinkers, A Harvard Business Review Book, 1994
[11] Hout, T., M. E. Porter, E. Rudden, *How global companies win out,* in: Harvard Business Review, September – October, 1982, pp.98-108
[12] *World Investment Report: Transnational Corporations and Export Competitiveness,* UNCTAD, New York and Geneva, 2002
[13] Ibid, pp. 12-14
[14] *World Investment Report 2000,* pp.xix - xxi
[15] Adapted from Table 8 of the World Investment Report 2002, pp. 16-17
[16] *World Investment Report 2003*
[17] Prahalad and Lieberthal call it “corporate imperialism” in: Prahalad C. K., K. Lieberthal, *The end of corporate imperialism,* Harvard Business Review, July-August 1998
[18] Ibid, p.70
[19] Li, J., *Foreign Entry and Survival: Effects of Strategic Choices on Performance in International Markets,* Strategic Management Journal, Volume 16, Issue No. 5, June 1995
[20] Ibid, p. 348
[21] Buckley, P. J., et. al., *Foreign market servicing strategies and competitiveness,* in: Journal of General Management, Vol. 17, No 2, Winter 1991, p. 37
[22] The ten countries discussed in this book
[23] Adapted from: *Brewing a giant,* in Warsaw Business Journal, May 12-18, 2003
[24] Adapted from: Krol, van der R., Eastward with success in glass, Financial Times, 14 July, 1993 and *Philips buys Polish light plant,* Financial Times, 17 June 1996
[25] *Japanese delight,* in: Business Central Europe, 4(36), 1996, p. 75
[26] Pavlinek, P., *Foreign Direct Investment in the Czech Republic,* in: The Professional Geographer: The Journal of the Association of American Geographers, volume 50, Washington, Association of American Geographers, 1998
[27] Lankes, H. P., A.J. Venables, *Foreign Direct Investments in Eastern Europe and the Former Soviet Union: results from a survey of investors,* EBRD, 1996
[28] Adapted from: Tüselmann, H. J., *German direct foreign investment in Eastern and Central Europe: relocation of German industry?* European Business Review, Vol. 99, Number 6, 1999, pp. 359-367
[29] Adapted from: *A light in Hungary: GE acquired Tungsram,* CIBER Case Collection, 1996 and Financial Times, March 17, 1993
[30] Adapted from: Financial Times, April 16, 1993; January 10, 1996

[31] UN ECE defines *"initial foreign investment"* as investment committed over the whole life span of the project (up to 25-40 years) and incorporate initial investment; in: East-West Investment News, No 1, 1995

[32] UN ECE defines *"total foreign investment"* as investment committed or effected during the first 1-4 years of project life; in; East-West Investment News, No 1, 1995

[33] Source: East-West Investment News, UN/ECE, No 2, 1995

[34] Pye, R., *Foreign Direct Investment in Central Europe: Experience of major Western investors,* European Management Journal, Vol. 16, No 4, pp. 378-389, 1998, p.385

[35] *World Investment Report 2000,* p. 123

[36] These are only orientation figures

[37] Adapted from: Tüselmann, H.-J., *German direct foreign investment in Eastern and Central Europe: relocation of German industry?,* European Business Review, Vol. 99, Number 6, 1999, pp. 359-367

[38] Lankes, H.P., A. J. Venables (1996)

[39] Tüselmann, H.-J., *German direct foreign investment in Eastern and Central Europe: relocation of German industry?,* European Business Review, Vol. 99, Number 6, 1999, p. 359

[40] Ibid, p. 365

[41] Hongarije zet in op een "Silicon Valley" bij Budapest, Het Financieele Dagblad, 5 August 2003

[42] *Developing onward,* interview with S. Pehrson, in: Budapest Business Journal, April 28 – May 4, 2003

[43] Adapted from: *Czechs see their country as a high-tech magnet,* in: International Herald Tribune, 5-6 April 2003

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PART III

STRATEGIES OF MULTINATIONALS TOWARDS CENTRAL AND EASTERN EUROPE

CASE STUDIES

Chapter 6

Automobile industry

1. INTRODUCTION

Since 1990 the automobile industry has moved rapidly eastward. The total investment in car manufacturing in Poland, Hungary, the Czech Republic and Slovakia represented about 14 percent of the total FDI accumulated in those countries in the last decade of the 20^{th} century. From almost zero in 1990, the production of cars in Central and Eastern Europe grew to more than six percent of the worldwide car production by the year 2000, outperforming Latin America.

Poland has attracted the largest number of investments in the industry and it holds a leading position among the four Central European countries where foreign car manufacturers have mainly settled their production (see Figure 6-1). The Czech Republic was the first to put its Skoda brand up for sale and thus attracted the largest single investment in the car industry in the region, as it is of Volkswagen. In addition, the Czech Republic is the country with the widest network of suppliers for the car industry in the CEE region, many of them being foreign companies.

The opening of the region has come at a time when Western car demand slowed down, pressing car manufacturers to restructure. As the cost base has always been one of the critical competition factors in the industry, Central and Eastern Europe was, in this respect, obviously offering attractive opportunities. In addition, car manufacturers tend to move their production closer to a growth market and therefore gain from effective logistics. Often struggling with overcapacity in their Western production units, car manufacturers have greater flexibility with regard to capacity in Central and

Eastern Europe (CEE). In addition, the level of production and the moderate market demands (in terms of price and models) gives foreign car manufacturers an opportunity to expand the life cycle of relatively out of date models. Last but not least, CEE countries offer attractive investment incentives that allow them to compete for foreign investment.

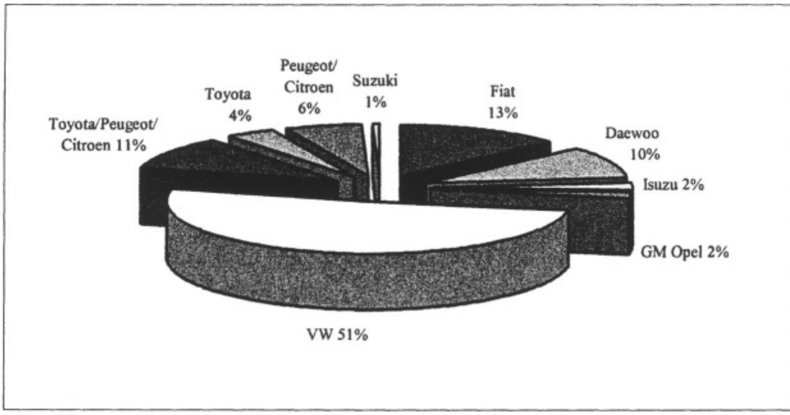


Figure 6-1. FDI in car industry (accumulative until 2002) [1]

2. INTERNATIONALISATION AND COMPETITION IN THE CAR INDUSTRY

Nowadays, there is very little that differentiates one automobile producer from another, although many companies may disagree with this statement. They also follow similar paths of internationalisation that begin with exporting directly from the home country and later through independent dealers. Next they move to establish foreign sales subsidiaries and very soon after that foreign production units.[2] This process can take a short period of time. Volkswagen, for example, has progressed through these four stages over a period of seven years. It started with exports, then with dealerships in the UK and later on with a production plant in Brazil in 1952.

Internationalisation has become one of the most powerful factors in global competition regarding companies in the automotive sector.[3] The major drive behind it is the combination of closeness to the markets and production efficiency. Efficiency has become crucial in the last decade as price/cost ratios are subject to a large amount of pressure. At present all car manufacturers consider the following issues crucial:

- Tight margins in high volumes: profit always looks illusive for popular cars;

– Strengthening the suppliers' network: rationalisation of the suppliers' chain;
– Common production platforms and innovation.

Companies show different approaches in reacting to these issues. The mother factory of Toyota Motor, Japan's largest automobile manufacturer, produces 700 000 units a year. It is the birthplace of *jodoka,* Toyota's catch phrase meaning "automation with human intelligence." Methods like "just-in-time-delivery" and *kaizen,* meaning continuous improvement, have kept Toyota in a strong position in the last 20 years. The need to review manufacturing costs and its relations with suppliers to ensure further profit, resulted in a new programme for internal restructuring called "Construction of Cost Competitiveness for the 21st century" (abbreviated as CCC21). The aim of the programme is to reduce costs by US$ 8 billion by the year 2005 and thus become more cost competitive. CCC21 resulted from a benchmark analysis with competitors and the outcome was that while quality was unrivalled, Toyota was slipping in cost reduction and parts procurements. The move coincides with a review of fixed expenditure, depreciation and research and development.

Toyota works with suppliers to cut costs by 30 percent on part and modular systems. The car manufacturer compares the lowest prices paid by its rivals for more than 170 basic components and asks suppliers to match the costs. Toyota will not impose what US automobile producers call "a haircut" on suppliers: rather it will seek changes in material costs and outsourced manufacturing systems to produce cheaper and better quality parts.

Following the traditional paternalistic Japanese practice of taking responsibility for your suppliers or buyers, Toyota has, on average, 25 percent equity stakes in most of its component suppliers. However this also has the disadvantages of over-capacity and inefficiency. Nissan and Mitsubishi are breaking apart their supplier *keiretsu.* Toyota has chosen to continue to honour the unspoken agreement with its suppliers, which is mirrored in a lifetime employment agreement. The fact that not one of Toyota's suppliers has closed in the past decade reflects the commitment Toyota has to its suppliers. At the same time, the output of the Group has decreased by 25 percent since its peak in 1990.[4]

Ford (the world's second largest car manufacturer) approaches the efficiency issue differently. It combines the consolidation of production through restructuring with the consolidation of production platforms and a new product offensive strategy. Following the traditional approach of American companies towards regional rather than countries' strategy, Ford has undertaken a restructuring of its European operations in recent times. It has closed down or cut back five plants and reduced its European capacity

by 20 percent. In the latest stage of its European restructuring, Ford cut 1400 jobs in Genk in Belgium. The plant there will be transformed into a "flex" plant where over the next two to three years different models will be assembled on the same line. In the UK, it is expected that about 1100 workers will leave the company when Ford ends car assembly at its Dagenham plant near London. Ford's new European strategy aims to generate a three percent return on sales by 2004. The result of the restructuring will be three fully flexible manufacturing plants in Europe – Valencia in Spain, Cologne in Germany and Genk in Belgium.[5]

In its' strive for efficiency, Volkswagen (VW, Europe's leading car manufacturer) has implemented a number of restructuring programmes over the last 20 years. Under Ferdinand Piëch, Chairman of the VW group from 1993 until 2002, the group initiated a suppliers restructuring programme. It required its suppliers to decrease costs by 5 percent to 10 percent aiming at a price reduction of components purchased from external suppliers by 25-30 percent over some 4-5 years.[6] The number of suppliers has been trimmed down from 900 to approximately 400. In addition, improving the suppliers network means building up strategic links with the so-called logistics suppliers – those who supply ready assembled parts. Included in the programme was the rationalisation of the product range by reducing the basic engineering structures (platforms).[7] Worldwide the number of platforms has been reduced from 16 to 4. The idea was that each platform is designed to accommodate a variety of styles allowing VW to produce cars to suit each brand and regional subsidiary. This "platform strategy" is meant to reduce development costs while offering substantial savings on production engineering. The economies of scale gained in making larger quantities of similar vehicles should also cut spending on components. There are two basic platforms – one for smaller cars and one for upper-medium-sized models. In 2001 VW reorganised its brands into two units: a conservative or traditional group including Skoda and Bentley and a sporty-brand family including Audi, Seat and Lamborghini.

Recently, senior management of Volkswagen under the Chairmanship of Bernd Pischetsrieder (since April 2002) has taken measures to oversee all overlapping products of the group's subsidiaries and thus remove competition between brands. VW has been criticised for sharing too many platforms and components between its brands.[8]

In terms of markets, automobile manufacturers do not have preferences regarding where to sell their products. However, they do have preferences regarding where to invest: the USA, China, Brazil, Mexico, Spain, Russia or Poland. The choice of a production base is mainly the result of several factors:

- Availability of a local brand to take over or local experience in car manufacturing to exploit;
- Cost structure and engineering skills;
- Easy import, easy export.

Being very vulnerable to economic slow downs, the automobile sector needs to spread the risk over a number of production bases. This offers flexibility in terms of the distribution of brand and product portfolios over the various production units, depending on their cost structure and market location. For instance, West European car manufacturers have moved their small and economy car manufacturing operations to Eastern Europe, creating more space in their home countries for product renewal in the upper end of the market.

The competition for market share launched an era of mergers and acquisitions in the automotive sector in the 90s. Volkswagen acquired Seat, the Spanish manufacturer in 1986 and Skoda, the Czech automobile producer in 1991, adding two established brands to its portfolio of economy cars. Acquiring brands automatically includes acquiring retail networks and markets, in this case Spain and a number of Eastern European countries. Later, in 1998, Volkswagen acquired Bentley, Bugatti, Lamborghini and Rolls Royce, further enlarging its Group (see Figure 6-2[9]). In 1999 the Volkswagen group owned 47 production and assembly plants worldwide.[10]

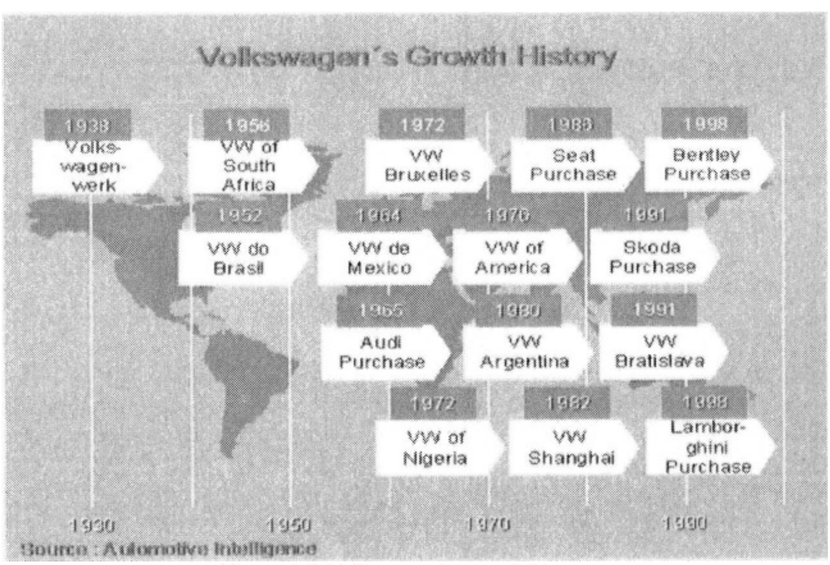


Figure 6-2. **Volkswagen's growth history**

During the 1990s, Renault signed a far-reaching alliance agreement with Volvo, the Swedish luxury car producer, in order to retain its ten percent

share of the European market. Consequently Renault-Volvo covered the widest product line in the automobile industry in Europe. The markets, in which Renault realised its production included France, Spain, Italy, the UK and West Germany.

3. THE MARKET OF CENTRAL AND EASTERN EUROPE

Central and Eastern Europe was a target market for car manufacturers from Western Europe before the changes of the 1990s. The Romanian car manufacturer "Dacia" produced the R21 under licence and in Eastern Germany Renault had a network of 200 dealers.[11] Fiat manufactured in Yugoslavia and under licence in Russia and Poland. The market of CEE for new light-vehicles was dominated by passenger cars produced in the USSR (e.g. Lada), Czechoslovakia (e.g. Skoda), Romania (e.g. Dacia) and East Germany (e.g. Warburg, Trabant). Imports of Western cars were limited and high import duties were imposed.

3.1 The history of investments

The real expansion towards Eastern Europe began around 1990 and was aided by the first purchase of an Eastern car manufacturer – Skoda, by Volkswagen in 1991. Volkswagen had built its success on a broad and growing presence in the region. While focusing its strategy on Skoda, it now makes cars in four countries and engines in three countries. The Group has maintained about a 20-22 percent market share in the region over the last few years. Skoda generated 62.4 percent of the total turnover of VW in the region in 1999.[12]

Between 1993 and 1995 Fiat was leading in the Central and Eastern European market with about 15-16 percent of market share. It invested US$ 1.4 billion into production in Poland, of which a large part was exported back to Western Europe. Due to its narrow focus in the region (e.g. production in Poland), Fiat has lost some of its competitiveness.

Soon after, Daewoo took the lead, purchasing seven car companies in the region, thus gaining a leading position in 1998 and 1999. Concerns about the future of the company have negatively influenced consumer confidence especially in Poland where Daewoo has located its largest companies in CEE.

Renault was the first to show interest in buying Skoda but Volkswagen won the deal. However, Renault acquired Dacia in 1999.

Daewoo, Fiat and VW captured 52.7 percent of the regional demand in 2000.[13]

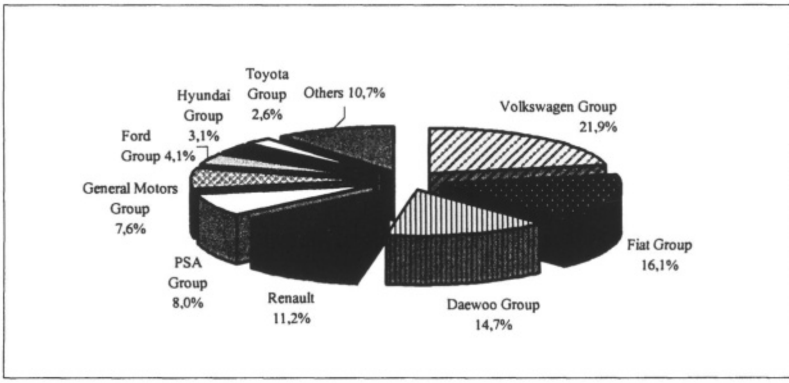


Figure 6-3. **Market share by car manufacturers in CEE**

PSA Peugeot-Citroën was the last to invest in production facilities in CEE. At the beginning of 2003 Peugeot Citroën signed a contract to build a new plant in (Middle) Poland for about € 700 million.

Japanese car manufacturers were one of the last manufacturers in the industry to discover the region of CEE, partly due to their careful approach towards foreign investment. Toyota has invested in Poland, the consortium Toyota-Peugeot in the Czech Republic and Suzuki produces in Hungary.

American car manufacturers follow the traditional perception of Europe as one market and concentrate regional production in a limited number of countries. General Motors has chosen Poland as the biggest market in the region where it produces the Astra Classic with the intention of covering Central Europe from there. Ford is also present in Poland and held about five percent of the market share in 1999 with a modest assembly plant.[14]

In total, 35 car manufacturers are active in the region and most have national distributors for each of the main markets in Central Europe and the Balkans. More than 5000 dealer outlets are open in Central Europe, with more than half representing Western brands.

The above history of eastward expansion of car manufacturers does not only concern the production of cars but of automobile parts as well as major suppliers have also established production in CEE.

3.2 Market potential

The region offers a large market with a growth potential that may compensate for the slowdown of Western demand. The potential size of the car market in CEE is approximately 45 million. In 1999, there were

approximately 110 cars per 1000 people in the region compared to 450 in Western Europe.[15] Only Slovenia, a country with a very small population, had almost reached the Western standard with 390 cars per 1000 people and with 42.3 new cars per 1000 against 40.5 for Western Europe. Despite economic turbulence CEE sustained yearly growth in its car market. The expectations are that imports will reach 54 percent of new car sales in the region by 2005.[16]

Poland, the **8th** largest consumer of new cars in Europe, leads the way with demand for its cars in the region, followed by the Czech Republic and Hungary.

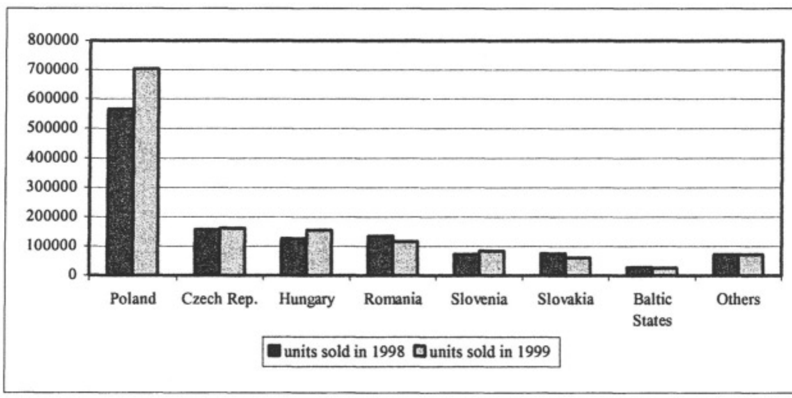


Figure 6-4. New vehicles in CEE[17]

The annual registration of new passenger cars doubled between 1995 and 2000. An important factor was the consumer behaviour towards Western and Eastern manufactured cars. Although both Skoda and Dacia priced their models favourably, they experienced difficulties in selling the cars in their own markets. After purchased Dacia, sales fell by 44.6 percent as a result of consumers waiting for the new "western-made" version.[18]

Skoda, for instance, carried the image from before 1989 for a long time: "one of the most reliable cars but very fragile and mainly suitable for women". Although Skoda is now part of the VW group, more time is needed, for instance, before an East European will prefer to buy Skoda instead of Golf. Customers often make a compromise given the choice between a second hand and a new car, preferring a used German-made car to a new Eastern European made one. One can gain the trust of the consumer with Western quality. While the failure of a Western-made car does not necessarily damage the image of the brand and is considered an exception, failure of a Skoda can be a decisive factor in the customer's choice of car. Skoda's CEO, Vratislav Kulhanek, says: "If one of our competitors makes a car that's poor quality, it's said to be an exception. If we make one, they say

Skoda has gone back to its old ways".[19] "We have to make cars that are a lot better than our competitors in order for people to say that we are just a little bit worse than they are. You can call it overcompensating for our past".

Serving the local market ("next door" market) is an attractive option since West European market growth for new cars is estimated to be up to 3 percent per year which will have to be shared with the Japanese. At the same time CEE is seen as a means to serve third countries in addition to the home market.

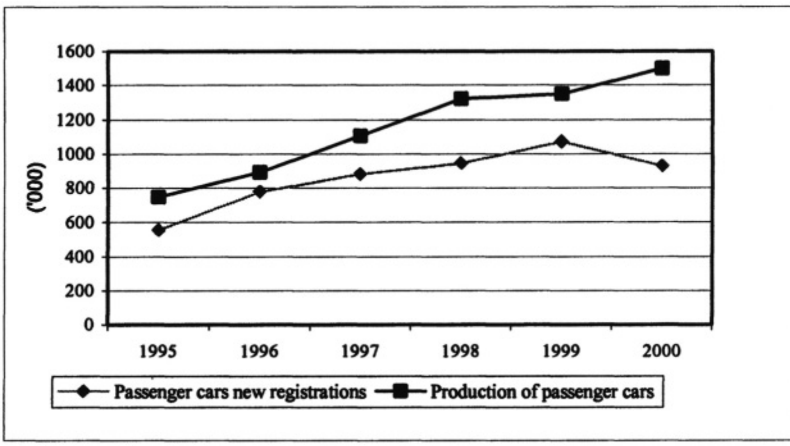


Figure 6-5. **Production and registration of passenger cars in CEE**[20]

Volkswagen has used Skoda Auto as its vehicle to expand into Central and Eastern Europe and the Balkans. For instance, VW has low-volume car assembly operations in Poland and Bosnia for its Skoda Felicia Model. In addition 90 percent of VW Polos (since 1999) and the four-wheel drive labour-intensive VW Golf and Bora models produced in Bratislava, Slovakia, are exported, including to the West. Toyota has created a new European production base in Poland that it intends to use to cover the entire European market.

At present companies are strengthening their market position through local production and dealerships, as well as brand awareness under protective conditions. Import tariffs on cars from the European Union (EU) are up to 20 percent in Poland and even up to 34 percent in the Czech Republic. The free movement of goods that will apply to the accession countries and the open competition on the European car market will boost the process of the re-distribution of car market shares in Europe.

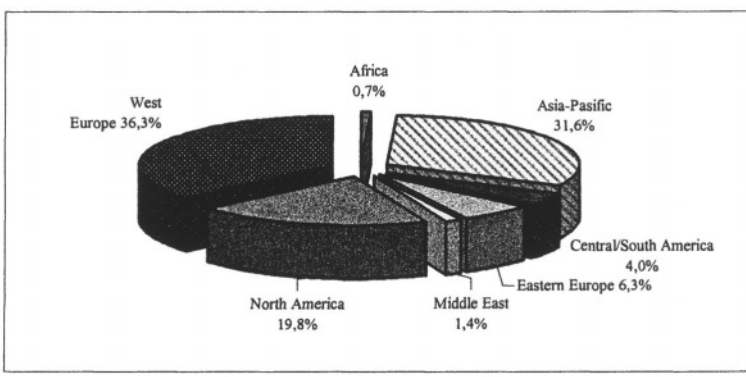
3.3 Strategic objectives

The drive to expand towards Central and Eastern Europe is a logical follow up to the global strategy of the automobile industry. In the beginning of the 20th century most car manufacturers were producers with a national image; nowadays the image is mainly built on brands and regions. Being global means addressing the same consumers as your competitor, maintaining a global scope of business activities and competing on a global scale. The two decisive factors needed to compete globally in the automobile sector are market share and profit margin. The competition in this sector is known to be based on very low margins and limited expansion of traditional markets. Therefore, any chance of entering new markets, especially if combined with low cost production, adds to the competitive advantage of the car manufacturer. Thus the two major investment objectives that have driven automobile companies to Central and Eastern Europe are:

- To get closer to the market;
- To reduce costs and boost productivity.

These two objectives have the following side effects for the producer:

- Restructuring of the production base for both final products and supplies;
- Restructuring of the product portfolio;
- Expansion into third countries.



Source: Data of Automotive Intelligence, www.autointell.com
Figure 6-6. Worldwide productions of cars (2000)

It should be noted that the strife of the automobile industry for globalisation has been and still is limited by regional access barriers. This has defined the regional character of the companies' policies rather than their global approach. By 1990 automobile industries and markets were heavily concentrated in three regions - the United States, Western Europe and Japan

- producing 82 percent of the world production and selling 80 percent in these markets.[21]

Of these three regions, only the USA market offered substantial growth potential. This was mainly noted by Japanese companies, which developed their production bases in the country. The years following the 1990s were characterised by a substantial shift of car producers outside of the three regions. The opening of the CEE markets had come just in time. Companies saw the region as an opportunity to compensate for the low growth in demand for cars, especially in Western Europe.

Regional and country barriers have hampered the access of Japanese companies into Europe. The Japanese share (imported cars) of the markets in France, Italy and Spain was about three percent during the 1990s as a result of the voluntary restraint agreement from 1986. The average EU market share of Japanese car producers was 12 percent, restricted by an import tariff of 10.3 percent.[22] The principle of fair trade was counterbalanced by the strong lobbying power of European car manufacturers. As a result, the European Commission reached an agreement with Japan to abolish the voluntary restraint agreements by 1993, applying a transition period of six years. The transition period was to allow the European car industry to adjust accordingly and at the same time to introduce import quotas for Japanese car producers that would allow them to capture no more than 16 percent of the EU market.

3.4 Determinants to invest

3.4.1 Optimisation of costs

While Western automobile manufacturers needed time and large investments to apply the Japanese approach of substituting labour with robots and implementing radical process innovations, they found the CEE region an immediate source of low cost production. Labour costs including social service payments in the Czech Republic were about 1/7th of those in Germany in 2001.[23] In 1999, the wages in Opel Polska were approximately 15 percent of the wages in Germany.[24] Absenteeism and paid holidays were low. The selection of personnel, for example, is based on high competition among well-educated people. Due to relatively high unemployment, the choice is wider than in Western Europe and the result is that most car manufacturers in CEE have a young staff with a technical or engineering degree. Of the employees at the General Motors factory in Hungary, 53 percent had high school, college or university education - a labour profile higher than that of GM in Germany. The influence of trade unions is, for

example, much less than in Germany and France and this allows for flexibility in labour conditions and labour mobility.

Low cost production as a basic consideration for investment in CEE concerns not only cars but automobile parts as well. Audi, for example, started manufacturing engines in Hungary (1 million units per year) and later with the assembly of the Audi TT Coupe (50 000 units per year.) For purposes of cost reduction, the body was produced and painted in Germany, then assembled in Hungary.[25] The sales director of Magyar Suzuki, Mr Tadashi Kondo, believed that Hungary was the best place for production where one could get a rather high quality labour force at reasonable cost.[26]

3.4.2 Optimisation of suppliers

Car manufacturers have brought their suppliers to CEE. Present in the region are Bosch, Continental, Johnson Controls, Hella, Hayes Lemmerz, Magna, Siemens, TRW, Valeo, Visteon, Delphi, Lear Corporation, Bosal, etc. Many Japanese suppliers have also recently moved to the region including Nippon Kayaku, Matsushita, Mitsubishi Electric, Furukawa Electric, Toyota Gosei amongst others. When Toyota started manufacturing in CEE, their suppliers came from Japan. However it slowly shifted to local suppliers. It also built its own factory for producing diesel engines next to its car factory in Poland. One job in a Toyota car factory creates two to three jobs with suppliers.

Volkswagen's investment decision in 1991 was followed by investment decisions of car component manufacturers. By 1999, nearly 80 foreign component makers had started operations in the Czech Republic alone, either as a greenfield investment or as a joint venture.[27]

Foreign investments boosted the development of the local auto-suppliers sector. In 1995, of Skoda's 416 suppliers, some 205 were from the Czech Republic, 18 from Slovakia and 193 from outside the country.[28] To a large extent this situation arose from the government's suppliers development programme, which aimed to help foreign manufacturers find supplies among Czech firms, as well as benefit from favourable investment incentive schemes.

Exports (60 percent of total production) of auto-components in the Czech Republic grew from almost zero in 1990 to US$ 3.6 billion in 2000. Ford has more than 20 key suppliers in the country plus a further 20 other suppliers. Opel has some 50 suppliers.[29]

3.4.3 Optimisation of product portfolio

While transferring the production of small and economy cars to CEE, Western manufacturers have made space in their home base for new models based on product and process innovations, which require large investments and exclusively high R&D skills. The latter provides the option of product portfolio optimisation, locating the "middle-lower" end of the car range in CEE and the top end in home countries. This was the basic drive of Renault when bidding for Skoda. Renault offers the widest product line of all the car manufacturers in Europe covering all major market segments – sub-compact, compact, mid-sized and full-sized, as well as the speciality segments – sport cars and minivan. "Volvo, our new partner could fill the top end of the car range, Renault could be positioned as the middle-of-the-road car and Skoda could be positioned at the lower end", was the idea of Renault's management in 1990.[30] Renault was planning to launch a micro sub-compact car (X06) between 1994 and 1995 and was seeking a suitable country, with low labour costs, for its production. Volkswagen markets Skoda on VW common platforms as a value-for-money VW car. VW has completely transferred its German production of the four-wheel drive Golf Synchro, family hatchbacks and estate cars to Bratislava. The Passat range, large family cars for sale in Slovakia and Eastern Europe, are also assembled there.[31]

3.4.4 Production optimisation

Most car manufacturers have built new factories in CEE where they have explored opportunities to introduce new methods and achieve high productivity from the beginning. Often only incremental changes take place in their home plants. General Motors (GM) has introduced 130 robots in its plant in Hungary; this represents the largest number ever in GM factories.

For some car manufacturers, CEE will become their automobile hub in Europe. Toyota, for instance, chose Poland as the largest production base for its cars in Europe. It invested in a new engine factory generating 350 jobs and 120 000 diesel engines a year for Toyota's British and Turkish assembly plants. In 2002 Toyota also opened a gearbox manufacturing plant and is expanding the plant to produce engines for the Toyota Peugeot Citroen Automobile joint venture in the Czech Republic.[32]

Toyota-Peugeot's recent (2001) commitment to investment in Kolin, the Czech Republic, will create 3 000 new jobs as of 2005 and will produce about 300 000 cars per year for the EU market.

3.5 Investment mode

The move to the East is a process following a number of steps such as:

- Assembly of semi-knocked down kits (SKD kits);
- Production of components;
- Search for local suppliers (for locally produced cars);
- Move to completely knocked down kits (CKD kits);
- Building the finishing operations locally;
- Establishing components production also to substitute or supplement western production;
- Building a network of reliable local suppliers (some of them being foreign investments of major auto-components suppliers in the West);
- Independent production of cars including design (e.g. Skoda).

Alongside the expansion of the production line, car manufacturers develop their local distribution and sales networks. The latter stage includes a move to upmarket products: larger cars produced on the same platform as the mother company.

Table 6-1. Major investments of carmakers to CEE (by 2002)[33]

Country/company	Investment in million US$	Form of investment
Poland:		
Fiat	2 000	Take-over
Daewoo	1 500	Take-over
Isuzu	364	New plant
GM Opel	300	New plant
VW	190	New plant
VW	175	New plant
Toyota	400	New plant
Toyota	170	New plant
Czech Republic:		
VW	4 300	Take-over
Toyota/Peugeot-Citroen	1 500	New plant
Slovak Republic:		
VW	1 500	Take-over
VW	200	New plant
PSA Peugeot-Citroen	700	New plant
Hungary:		
Audi	1 300	New plant
Suzuki	100	New plant
GM Opel	n.a.	New plant

Most of the investors prefer greenfield operations (see Table 6-1) unless there is a one-off opportunity to buy out a local car brand producer (e.g. Volkswagen and Skoda, Renault and Dacia) or a local company in the automobile business (e.g. Fiat in Poland, VW in Slovakia, Daewoo in Poland). Most of the investors also prefer majority ownership. In the case of Volkswagen-Skoda, the Czech government sold 31 percent of the equity in 1991 but it was not difficult to increase it to 70 percent by 1995, or to negotiate the price for the remaining 30 percent.

Greenfield operations offer a number of attractive incentives:

- The design of the factory is not limited by previous production facilities;
- Cleared environmental liabilities;
- A wider choice of locations is available;
- Preferential offers by the state for locations in special industrial zones;
- No social burdens inherited from the existing company;
- No internal organisational restructuring is required;
- Open selection of employees within newly developed labour conditions.

Joint ventures with local car manufacturers offer:

- A local producer with experience in car manufacturing;
- A dealer network in CEE;
- A network of suppliers;
- R&D potential;
- No time lag for the start up of operations.

Most investors benefit from investment incentives or special investment packages offered by the countries. In return they offer an investment programme aimed at production growth, new job creation, training of local employees and development of the supply base in the country. Poland, Hungary and the Czech Republic have competed strongly for the largest investments in automobile manufacturing. For example the Czech Republic has built up a combination of incentives and a well co-ordinated mechanism to attract investors via its foreign investment agency, CzechInvest. The following incentives and economic policy mechanisms have played and continue to play an important role:

- Tax relief, job creation grants, training grants, provision of low cost building, land, and other infrastructure elements;
- Duty free import of machinery;
- Development of industrial zones: grants to municipalities, the transfer of land to municipalities for discount prices;
- Supplier development programme: upgrading local, potential suppliers and bringing them together with foreign investors;

– Support from local governments: job creation grants and training and re-training grants.

Some of the car manufacturers saw benefits from their immediate entry into the region. For instance Volkswagen achieved the largest share of the CEE market – 21.9 percent by 2000. Volkswagen also opted for wide coverage of production bases in a number of countries. Daewoo followed the same strategy, while Fiat preferred a narrow approach, serving the region mainly from its home base. Others decided to concentrate large production capacities in limited locations (GM, Toyota) and serve the rest of the region from there.

Although the first investor always gains advantage, the last investor certainly benefits from their experience. Toyota and Peugeot-Citroen decided to invest in the Czech Republic in 2002. The consortium was attracted by an offer that made them switch from the opportunities they had in Poland. Their decision was very much influenced by the fact that the Czech Republic could offer approximately 270 suppliers in the automobile sector against only 40 in Poland. Total investment in the sector in Poland was US$ 5.3 billion in 2002 while the Czech Republic, at four times smaller, accumulated US$ 5 billion. Thus the "snow ball effect" has played a role in the latter stages of investment in the region's automobile sector.

It is interesting to consider the first experiment of Toyota and Peugeot-Citroen who are building a plant together in CEE. Three different models of Toyota and Peugeot will be produced in the plant in Kolin (the Czech Republic). The reason for this experiment is the competition not only on a worldwide basis but also from countries within the CEE region.

The most recent company to invest in CEE was Peugeot Citroen. The company had been looking for a site since 2001. After strong competition between Poland, the Czech Republic and Hungary, Slovakia was the country chosen by the Group. The new factory is expected to have a capacity of approximately 300 000 small cars annually and should create around 3 500 new direct and 6 000 related jobs after production starts in 2006. It is believed that the French investor decided on the region of Trnava for production because of a favourable strategic position. They were offered a 190-hectare area that provides easy access to the country's infrastructure. In addition, the possibility to establish a suppliers' hub nearby was attractive. The Slovak tradition in automobile production played an important role as well.[34]

Almost all foreign car producers in the region reported increases in follow-up investments in order to support increases in production capacities. The average capacity per plant is around 300 000 cars per year. Skoda owns the largest factory with about 500 000 units per annum.

Most car manufacturers prefer to maintain their major R&D skills at home. Local engineers carry out some R&D work on product development related to the ongoing production.

4. VOLKSWAGEN'S CHECK LIST OF SUCCESS

The success story that everyone refers to regarding foreign car manufacturers investing in the region of CEE is the Volkswagen-Skoda investment. Volkswagen has used *Skoda Automobilova* as its vehicle for expansion into CEE. Skoda is the largest carmaker in the region and has powered VW brands to rank in first position in terms of sales.

4.1 History of the investment

In 1991 Volkswagen and the Czech government agreed on the contract concerning the Czech car producer *Skoda Automobilova.* Volkswagen bought a 31 percent share of *Skoda*, promising to invest DM 9.5 billion into the factory, to retain 21 000 of its employees and to use Czech suppliers. In 1994 the Czech government increased Volkswagen's share up to 61 percent and up to 70 percent in 1995. Later on Volkswagen lowered its investment plan from DM 9.5 to 3.7 billion and cancelled its plan to build a new engine plant. Volkswagen's investment of US$ 900 million became the largest investment into the manufacturing sector in the Czech Republic and the second largest investment in the Czech Republic overall.[35] Volkswagen's investment represents about half of the total foreign investments into the car industry in the region (see Figure 1).

4.2 Negotiations

Volkswagen was the preferred investor, competing at the time of negotiations with Renault. Skoda came out of the negotiations with a clear position on ten points, including investments in production, which should account for 350 000–400 000 units per year from 1990 to 2000 and the provision of immediate access to engine production know-how in order to upgrade the Favorit model and to meet the requirements of the European market. Skoda had to keep its R&D department and its brand name for the new models. What was very important for Skoda was to have access to their partner's sales network, because their team lacked experience in the fields of marketing and distribution policies. For a time the Czech government's ownership was maintained but that was a matter of future change. Another point, which also needed to be reconsidered, was Skoda's requirement to

maintain its number of staff, which in the long run seemed to be impossible due to the modernisation of facilities and the more profit-oriented management of the new joint venture.

While Renault representatives spent a considerable amount of time talking to a large number of government officials, Volkswagen concentrated on discussions with Skoda's management and visits to the plant. While Renault was not well acquainted with the country, Volkswagen had been there before – since 1986 when Skoda was looking for a partner for new engine development. Volkswagen's CEO visited the company soon after the changes in Czechoslovakia. Volkswagen also offered to treat Skoda as another brand alongside Volkswagen, Audi and Seat, whereas Renault had the intention of starting up production of its own brand product. Volkswagen could also demonstrate its ability in such situations through the successful take-over of another local car brand manufacturer – Seat in Spain. Under the proposal of VW the production of a slightly modified car would continue with a new jointly developed model to be introduced later.[36]

4.3 Products

Skoda produces four ranges of cars: Favorit, Felicia, Octavia and the newest model Fabia. They have been developed and introduced gradually. The Felicia, a revised version of Favorit that combines space, toughness and flexibility at a low price, was launched in 1994.[37] The 1996 Octavia range of small family cars enabled Volkswagen to compete in the largest volume segment of the European market, against models such as the Ford Escort and Opel Astra.[38] The third range of larger cars, Fabia, was launched between 2000 and 2001. Volkswagen introduced three new models within ten years, manufactured on Volkswagen's common platform. At the same time, the cars are tailored to meet Eastern Europe's needs. The Felicia, for example, is compact but spacious enough to carry a family. The interior design allows for private and business use, while the suspension is designed to cope with the cratered roads of Eastern Europe.[39] The group of 700 R&D staff members, headed by a German R&D director are geared to work on the introduction of new models.

From the start Volkswagen applied the competition principles within the car industry to Skoda: lower break-even volumes based on improved production methods, reduction of labour costs (layoff's) and better component sourcing.

4.4 Financial results

A year-by-year improvement of Skoda's financial results could be observed after 1996.[40] This was partly attributable to the different accountancy practices in place within the country. In 1998 profit more than tripled, sales increased by 8.1 percent and exports to Western Europe doubled. The financial skills, therefore, had to be considerably improved.

4.5 Market performance

The Volkswagen Group has managed to achieve the strongest position in the Eastern European market, increasing its share every year. In 1999 the Group's share reached 20.8 percent followed by Fiat Group with 16.1 percent. Skoda itself accounted for 12.9 percent of the Eastern European new light-vehicle market.[41] Skoda exports its cars into four main markets: Germany, Great Britain, Slovakia and Poland. A study by JD Power, a US automobile consultancy, ranked Skoda in sixth place in terms of customer satisfaction in the UK in 1995.[42] Quality is the basis for market performance. The first Octavia model damaged the image of Skoda due to its poor quality and sales fell worldwide from 47 percent in 1998 to 37.2 percent at the beginning of 1999. At present Skoda cars manufactured on VW common platforms are marketed as a value-for-money VW's.

4.6 VW's suppliers

Skoda's suppliers are required to meet high quality standards. VW's policy to build up a network of local suppliers resulted in half of their suppliers being Czech. About 50 joint ventures between Western component producers and Czech suppliers were formed as well as 20 greenfield operations for component plants were established by foreign investors as a spin-off of Volkswagen's investment in Skoda.[43]

4.7 Human factor

It was not only the low labour costs that were of interest to Volkswagen. More attractive was the engineering tradition of Skoda that could not be found anywhere else in the region. "You cannot but be optimistic when you think of how utterly European these people are in their cultural and industrial heritage", said Volkswagen's Management Board Chairman (from 1982 until 1993) Carl Hahn in an interview in 1991.[44] Volkswagen has maintained the engineering potential of Skoda. The financial skills, however, needed substantial improvement. German participation in Skoda raised the level of

managerial skills. In 1998 about 150 Western managers were employed in Skoda plants and Czech managers as well as selected workers underwent training.[45]

5. CONCLUSIONS

It is perhaps a coincidence that opportunities to invest in the automobile industry of Central and Eastern Europe came at a time when car manufacturers faced low demand in Western markets. At the same time, carmakers had been struggling to achieve more and more efficiency that would drive down the costs and therefore provide a competitive advantage. The CEE countries were clearly offering possibilities to achieve more efficiency based on low-cost inputs in manufacturing based on their territories. This drove Western automobile producers to the region. In just one decade almost all carmakers were present in CEE, although their strategies vary. While Volkswagen aimed for wide country's coverage, Fiat preferred a narrow focus. While Toyota opted for one production platform from which to serve the European market, Daewoo spread its investment, following a number of attractive investment opportunities available in the region and faced the problem of managing all of them effectively at the end.

Two major *investment objectives* have driven carmakers to Central and Eastern Europe: market expansion and reduction of costs. The region offers a market with a growth potential of approximately 300 percent as of 2000. Although the cost structure in CEE is developing and many of the cost elements become more expensive each year, the level is still at least 70 percent lower than that found in the home countries of the automobile manufacturers. In addition, the level of education of the workers in the CEE manufacturing plants is often considerably higher than in the home based factories.

Four *investment determinants* are important for automobile producers when investing in CEE:

- Optimisation of costs;
- Optimisation of suppliers;
- Optimisation of product portfolio;
- Optimisation of production.

As for the investment mode, most car manufacturers prefer greenfield operations unless there is a one-off opportunity to buy out a local car brand producer. Most of the investors also prefer majority ownership.

Some of the car manufacturers saw benefits from their immediate entry into the region. Although the first investor always gains advantage, the last investor certainly benefits from their experience.

Car manufacturers often transfer all parts of the supply, production and distribution chain to CEE. What they have kept for themselves is their major R&D activity that remains at home for the time being.

Most investors benefited from investment incentives or special investment packages offered by the countries. In return they offered an investment programme aimed at production growth, new job creation, training of local employees and development of the supply base in the country.

There is a fear among the employees in the home-based car manufacturers (e.g. Germany) that eastward expansion of the automobile industry threatens their jobs. It is our belief that this fear may become a reality if:

a) CEE manufacturers sustain their cost advantages combined with increasing productivity in the coming 7-10 years;
b) CEE car producers maintain a high quality production that does not differ from the one achieved in the home based plants;
c) CEE continues to develop a wide network of local suppliers of high quality and relatively low prices;
d) CEE maintains labour conditions where the employer can hire and fire relatively easy and without much related costs;
e) CEE develops R&D skills and knowledge that can compete with the ones that exist in the home-based production plants;
f) Western manufacturers do not move up the market;
g) Western carmakers fail to segment even more the stagnated Western market and therefore increase their market shares;
h) Western carmakers do not develop stronger R&D based production;
i) Western trade unions and workers' councils do not compromise between job security and the need for efficiency.

The automobile industry is one of the most expressive examples of an industry's move towards an emerging market where carmakers can develop a long lasting interest. As a result, countries like the Czech Republic, Poland and lately the Slovak Republic have the chance to become the new auto-hubs of Europe.

NOTES

[1] Source: A number of various publications in the period 1989–2002, most of them quoted under these notes

[2] The so-called "Uppsala Model" described by Johanson and Wiedersheim-Paul (1975) and Johanson and Vahlne (1977). They focused on the internationalisation of Swedish companies and developed a model of a company's choices and forms of entry when going abroad. Johanson, J., Vahlne, J.E., The internationalisation of the firm – four Swedish cases, Journal of Management Studies, Vol. 12, No 3, October, 1975

[3] In this case we consider passenger cars only

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[4] A very benevolent restructuring, the car maker wants to trim costs etc., in Financial Times, December 13, 2001

[5] Ford to shed 1400 jobs at Belgium assembly plant, in Financial Times, February 15, 2002

[6] VW steps up the pressure on suppliers, in Financial Times, March 4, 1993

[7] Relentless driver of change, Interview with Ferdinand Piëch, in Financial Times, August 29, 1996

[8] VW forms product strategy committee, Financial Times, March 6, 2002

[9] Source: http://www.autointell.com/european_companies/volkswagen/vw_marke/volkswag 17

[10] Jurgens, U., Internationalisation strategies of Japanese and German automobile companies, 1992, p.66

[11] Henderson, J., Skoda-Volkswagen-Renault negotiations (A): the Renault-Volvo proposal, IMD, Lausanne, Switzerland, 1992

[12] VW maintains its sales pole position, in Financial Times, February 29, 2000

[13] Volkswagen buoyant in sinking market, in Financial times, September 21, 2000

[14] Record sales, but "goodbye" to the locals, in Financial Times, March 1, 1999

[15] Western investment rewarded with growth, in Financial Times, March 1, 1999

[16] Eastern Europe car demand to strengthen, in Financial Times, September 24, 1996

[17] Sources: Financial Times, September, 21, 2000 and Financial Times, February 29, 2000

[18] Volkswagen buoyant in sinking market, in Financial Times, September 21, 2000

[19] A new set of wheels, in CEER, February 1999

[20] Source: Financial Times, September 21, 2000

[21] Volkswagen facing Japanese Competition, INSEAD Euro-Asia Centre, France, 1992

[22] Ibid

[23] The Czech automobile sector, CzechInvest Report, August 9, 2002

[24] Western investment rewarded with growth, in Financial Times, March 1, 1999

[25] Rich expertise is tapped, in Financial Times, March 1, 1999

[26] Ibid

[27] The Czech automobile sector, CzechInvest Report, August 9, 2002

[28] Pavlinek, P., Foreign Direct Investment in the Czech Republic, in: Professional Geographer, Volume 50, Number 1, February 1998

[29] The Czech automobile sector, CzechInvest Report, August 9, 2002

[30] Henderson, J., Skoda-Volkswagen-Renaultnegotiations (A): the Renault-Volvo proposal, IMD, Lausanne, Switzerland, 1992, p. 1

[31] Volkswagen is switching work to low cost unit in Slovakia, in Financial Times, 1995

[32] Another investment of Toyota in Poland, TMC and TICO press release

[33] The data in the table are adapted by the author from different sources. Data do not include the car component sector.

[34] Concern PSA Peugeot Citroën enters Slovakia, news report from SARIO's website

[35] The Czech cabinet is expected to decide in three or four weeks on the future of its 30 percent stake in Skoda Auto, in Financial Times, January 28, 2000

[36] Henderson, J., Skoda-Volkswagen-Renault negotiations (A): the Renault-Volvo proposal, IMD, Lausanne, Switzerland, 1992

[37] VW helps Skoda turn the corner, in Financial Times, October 14-15, 1995

[38] Skoda to lead Volkswagen's big drive east, in Financial Times, April 12, 1996

[39] Quotated by Volkhard Kohler, Skoda Deputy Chairman in: "VW helps Skoda turn the corner", in Financial Times October 14-15, 1995

[40] Skoda to lead Volkswagen's big drive east, in Financial Times, April 12, 1996

[41] Volkswagen buoyant in sinking market, in Financial times, September 21, 2000

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[42] VW helps Skoda turn the comer, in Financial Times, October 14-15, 1995

[43] VW cancels finance deal of $860m for Skoda in Financial Times, September 9, 1993

[44] Avishai, B., A European platform for global competition: an interview with the VW's Carl Hahn, Harvard Business Review, July-August, 1991 .

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Chapter 7

International banking: ING Bank

1. INTRODUCTION

After a decade of financial chaos, where banks were one of the major sources to become quickly rich through everlasting loans and money laundering, Central and Eastern Europe is now under pressure to show clean, fair, transparent and efficient financial systems. The countries in accession were obliged to fulfil the requirements laid in 31 Chapters by the European Commission. Many of these requirements concern laws and regulations that harmonise countries' financial and fiscal systems with those of the EU member states. Since banks account for 80 percent of the financial assets' in the region, they are seen as the core institutions to lead the financial reforms.

After severe financial crises that have hit every country in the region in mid-1990s, international banks have quickly found their place in restoring the trust in banks. Mainly through privatisation, major local banks were taken over by foreign financial groups. Some banks such as ING have entered the region before the privatisation process started, establishing their independent branches as a greenfield operation.

Serving corporate clients as a starting portfolio, foreign banks in CEE moved to retailing where the region still provides ample opportunities. Credit and debit cards, asset management, pension and insurance, mortgages have started from scratch and are under development.

In many instances the eastward expansion of the Western European financial groups is seen as extension of the home market and the development of a broader base in the future larger Europe.

Foreign banks in CEE are seen to contribute substantially to the clean up of balance sheets and investments, in training and technology, making the financial sector a model of efficiency and stability in the region.

2. EASTWARD EXPANSION OF THE BANKING SECTOR

In 1999 there were about 100 major banks in Central and Eastern Europe with total assets of about US$ 200 billion, less than half of those of the largest single banks in the UK, Switzerland, France, Germany or the Netherlands.[2] The largest bank in the region, Poland's PKO BP, with assets of € 14, 6 billion at the end of 1999, would not make the top 30 in Germany. In 1999, in the Czech Republic, the deposits were 50 percent of the GDP whereas in Western Europe this figure was a multiple of the GDP. With loans, the situation was the same. Loans in Poland accounted for 30 percent of GDP and in Hungary for about 70 percent in 2000.[3] Total bank assets in the region equalled to 60 percent of GDP in 2000 compared to 254 percent for the euro-zone average.[4]

The pioneer foreign investors in the region's banking sector – notably the Dutch groups ING and ABN AMRO and the US Citigroup, invested mainly in greenfield ventures or in small local banks. Following them, most recent investors have concentrated on bidding for state banks that were up for privatisation (see Table 7-1).

Citibank (since 1991 in Poland) started with financing only large multinationals and local companies before expanding into consumer credits in 1997 and opening a unit on small- and medium credits in 1998. Although outside the US the bank normally expands through organic growth under its own brand name, the takeover of the Polish Handlowy avoids years of costly investment and recruitment. "If you don't establish a strong market share now, it's hard to do it later," says Shirish Apte, president of the bank's Polish operations.[5]

The first group of foreign investors in the financial sector in CEE are banks with a strategy of entering any emerging market with growth potential (e.g. Citigroup - the world largest financial group). "Emerging markets spend 1 percent of GDP on insurance premiums compared to 9 percent in the US. We prefer to go to places where it is 1 percent". This is how Sandy Weill, Chairman and CEO of Citigroup, explains the preference of the bank for such regions as Central and Eastern Europe.[6]

The second group of foreign financial institutions investing in CEE are those from neighbouring countries. They see CEE countries as an extension of their home markets (e.g. Austrian and German banks in the Czech

Republic, Hungary and Slovakia; Scandinavian banks – in the Baltic states, where they control more than half of the financial market).

Table 7-1. Presence of international banks through privatisation in Central and Eastern Europe[7]

Country	Privatised Bank	Foreign ownership
Bulgaria	Bulbank	Unicredito
	United Bulgarian	National Bank of Greece
	Expressbank	Société Générale
Czech Republic	CSOB	KBC (82%)
	Ceska Sporitelna	Erste Bank (53%)
	Zivnostenska banka	Banka Bankgesellschaft Berlin
	Agrobanka	GE Capital
	Komercni Banka	Société Générale, Unicredito
Estonia	Hansabank	SEBSwedbank
	Eesti Unisbank	SEB Sedbank
	Optiva (new name Sampo Bank)	Sampo Bank
Hungary	K&H (and ABN AMRO Magyar)	KBC and ABN AMRO
	MKB	Bayerische Landesbank, BAWAG
	Budapest Bank	GE Capital
	CIB	Intesa
	OTP (the largest bank in the country)	Local and foreign shareholders without strategic partner
Latvia	Unibanka	SEB Sedbank
	Hansabank Latvja	SEB Sedbank
Lithuania	Vilniuas Bank	SEB Sedbank
Poland	PEKAO S.A.	Unicredito (50%)
	Bank Slaski	ING
	Zahodni WBK	Allied Irish Banks
	Kredyt Bank	KBC
	BRE	Commerzbank
	BPH	Hypovereinsbank
	Interbank	ABN AMRO
	Bank Handlowy	Citigroup (66%)
	PBK	Bank Austria (part of Hypovereinsbank - Germany) (53%)
Romania	Banca Romana Pentru Dezvoltare	Société Générale
	Banca Agricola	RZB
Slovakia	Tatra Banka	RZB
	Polno'Banka	Unicredito
	Slovenska Sporitelna	Erste Bank
	VUB	Intesa
Slovenia	SKB Banka	Société Générale

The third group of banks are West European banking groups with low growth potential in their home markets. They include Ireland's Allied Irish Banks, which has two Polish subsidiaries, and KBC of Belgium, which owns the Czech Republic's largest bank as well as operations in Hungary and Poland. Italy's Unicredito, prevented from acquiring a large rival at home, has stakes in Poland, Bulgaria and Slovakia.

West European banks from small countries such as Belgium, Ireland, the Netherlands and Portugal, face consolidation trends within the EU. These banks have gone east in search of the critical mass needed to compete with big rivals. As Herman Agneesens, managing director of KBC, Belgium, says: "Eastern and Central Europe is our big opportunity to build a bigger base. This can be our second home market".[8]

In addition, banking groups do apply different strategies in CEE countries. KBC for instance goes for a broad portfolio and uses bank networks for selling insurance services. GE Capital is strong in consumer finance. Erste Bank focussed on savings as a priority business.

Banks were cautious with extending loans. Therefore the first priority of all international banks in the region was to gather assets in order to be prepared for a more active lending policy in the future.

The greatest expansion is expected to be retailing. Credit cards develop slowly in need to overcome the consumer trust in them. The consumer finance is in its infancy. The sector needs another 10-20 years to reach the level of the EU.

By 2000, 70 percent of the banking sector in Poland and Hungary was controlled by foreign groups.[9] The three largest banks in the region, Germany's Hypovereinsbank, which completed a € 7 billion merger with Bank of Austria in 2000, KBC of Belgium and Italy's Unicredito, already have nearly 30 percent of the foreign banks' share of their regional market. The market share of international banks in the region has increased from 20 percent in 1997 to 41 percent at the end of 2000 (see Table 7-2).[10]

Table 7-2. Share of foreign banks in selected CEE countries in 2001[11]

Country	Total bank assets of foreign banks (€ billion)	Total bank assets of local banks (€ billion)
Bulgaria	2.3	1.9
Czech Republic	34	36.1
Hungary	15.6	15.1
Poland	40	51.1
Romania	1.8	8.1
Slovakia	4.6	13.5
Slovenia	1.4	12.5

By 2000 there were about 77 banks in Poland and 44 banks in Hungary (the latter for only 10 million population). The region is seen as

"overbanked" at present. Next to the foreign banks, there are a number of local banks albeit with insufficient competitive power. A tendency of consolidation can be observed in the last 2-3 years. For instance, ABN AMRO merged its Hungarian Magyar Bank subsidiary into KBC's Hungarian subsidiary in 2000. ING sold its Hungarian interest to Citigroup. The tendency of continuing consolidation is expected to result in a banking sector, concentrated in a few banks, mainly foreign owned.

3. ING GROUP

ING Groep N.V. is a global financial institution that offers banking, insurance and asset management to approximately 60 million clients in more than 65 countries with over 110 000 employees. ING worldwide has more than € 700 billion in total assets. It is the 16th largest financial group in the world, the 7th largest Europe-based financial group, the No.1 financial group in the Netherlands, the No.1 in US life/annuity premiums, the No.1 broker/dealer network in the USA, the No.1 life insurer in South America and the No.1 life insurer in Central Europe (see Figure 7-1).

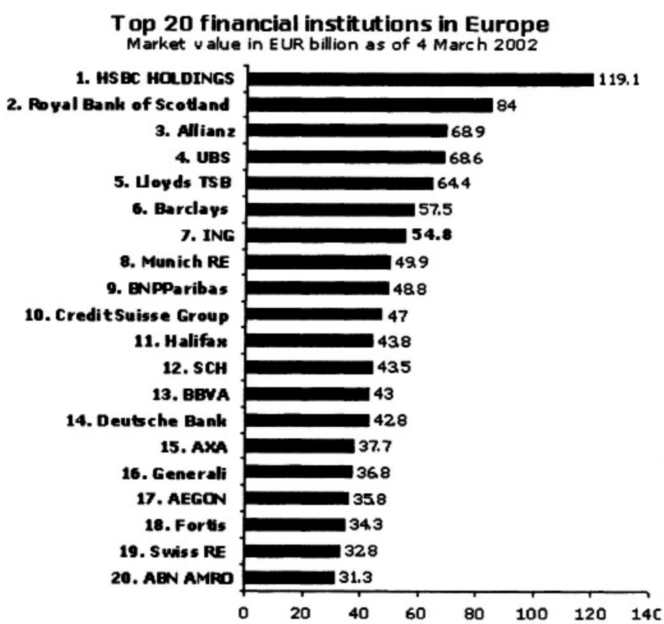

Figure 7-1. Top 20 financial institutions in Europe[12]

ING Group is a result of the merger between the NMB Postbank Group (that resulted from a merger of NMB Bank and Postbank in 1989) and the Nationale Nederlanden insurance group in 1991. As a consequence of the different specialisations of the financial institutions (NMB Bank in the corporate banking sector and international banking, Postbank with its important role in the Dutch retail market and Nationale Nederlanden as the largest Dutch insurer) the ING Group is a diversified international financial group with a banking and an insurance arm. The basic idea of the merger was to sell banking services through the insurance arm and to sell insurance products through the bank's network. Furthermore, it was essential to create a single organisation with a clear identity of purpose not only in the Netherlands but also in Europe and beyond.[13] The concept of cross marketing of products is also named 'bancassurance'[14] though ING took a broader view in 1996. Aad Jacobs, former CEO of ING Group, saw the combination as offering a spectrum of financing to corporate clients, with the banking side of ING providing shorter-term borrowing, while the insurance side offers longer-term financial support.[15]

4. STRATEGY AND ORGANISATIONAL STRUCTURE

4.1 Internationalisation

Clear strategic focus has become important for Dutch banks since they have to operate in a highly 'overbanked' country where many of the same services are offered by all financial institutions. The merger of ABN Amro was based on the premise that two large banks together could resist attacks from foreign banks, realise substantial cost savings and carry out major acquisitions themselves. Rabobank had decided to co-operate with Robeco and to intensify the alliance with Interpolis, also a response to the concept of 'bancassurance'.

At ING Group, a three members' group is in charge for the strategy. This group acts as a catalyst between the Board of Directors, the organisation and the outside world. Strategy development is a dynamic process. This means that the fundamental strategy can be adjusted to the changing environment continuously. This is called the Model of Adjustment ('Bijsturingsmodel'). Hence, a fundamental strategy is available and occasionally the managers tip at a promising area where thanks to existing know-how the Group can position itself. This is called a 'focus strategy', a specialisation on a specific

segment of a market.[16] This focus strategy is the underlying strategy of ING Group and explains why ING Group is very active in some markets.

As mentioned before, NMB-Postbank and Nationale Nederlanden merged because they wanted to sell banking services via the insurance arm and to sell insurance products via the bank's network. This was the fundamental strategy of the merger. In the period just after the merger all attention was spent to the combinations of banking and insurance products. At that time, the focus was on the expansion of the retail activities, asset management and corporate banking. In the middle of 1994, the international strategy was redefined and the strategy focused on the possibilities of integrated services outside the Netherlands.[17] In addition, investment banking and asset management had the opportunity to expand outside the Netherlands[18] . The expansion of these strategic priorities has materialised through the acquisition of the British merchant bank Barings.

As the list of companies interesting for ING Group to take over or merge was composed much in advance, the acquisition of Barings took only ten days. Barings could not only fulfil the aspirations of ING Group in investment banking and asset management, it also had an outstanding emerging markets' department (especially for Far East region) that complemented ING's market position in the emerging markets.

ING Group is divided into four segments: ING Europe, ING Americas, ING Asia/Pacific and ING Asset Management. The organisational structure with three-regions allows for strategic objectives for each of the three regions: America, Europe and Asia/Pacific.

ING Americas is comprised of business units operating in three broad geographic-based units in the United States, Canada and Latin America. The primary products and services provided in ING Americas' units are various types of insurance, mutual funds, brokerage services and institutional products, including reinsurance and guaranteed investment contracts. ING Americas offers other products and services, including corporate and investment banking as well as retail and institutional asset management, in these geographic areas through businesses in other globally focused executive centres. Of special attention in this region are Mexico, the United States and Canada where ING has acquired shares in local companies.

ING Europe's strategy is to have substantial retail and wholesale market shares in its home markets and to offer its retail, corporate and institutional clients a comprehensive range of insurance, asset management and banking services. The company has over 16 million European retail clients, most of which are based in its home markets of the Netherlands (54%), Belgium (15%) and Poland (15%), where clients are offered a full range of banking, insurance and asset management services through a wide choice of channels. This wholesale strategy is to offer the company's global and European

corporate and institutional clients a comprehensive range of corporate and investment banking services, and tailor-made advisory and structured products.

ING Asia/Pacific is responsible for ING Group's retail strategy in delivering integrated financial services in the key markets in the Asia/Pacific region. A functional regional office in Hong Kong supports all business units in the region, ensures that strategy is implemented, encourages synergy both regionally and globally, and reports on a consolidated basis to headquarters in Amsterdam. ING Asia/Pacific focuses on the individual and small and medium enterprises markets, providing a full range of products distributed via the channel of choice of the customer. Within the region, markets develop and mature, following regulatory reform and the expectations of the community; as a result ING Group's strategies in the region vary by country and market. A major strategic focus for ING Asia/Pacific was to develop scale and effective presence in its key markets. In 2000 this strategy was strongly augmented by the ING Group's acquisition of Aetna's financial services businesses in Asia/Pacific. Following closure of the Aetna transaction in December 2000, the integration and alignment increased market positions in Taiwan, Malaysia, Hong Kong and Indonesia, while supporting ING Group's existing presence in Australia, Japan and Korea.

Under the ING brand the Group primarily offers retail and wholesale financial services. Recently ING announced further steps towards creating a single global brand that will see its key businesses in the Netherlands and Belgium more closely align to the ING name. The move follows similar initiatives by other parts of ING global business of banking, insurance and asset management in the United States, Mexico, Chile, Poland, the Czech Republic, Taiwan and Malaysia.[19] "More and more countries and businesses are using the ING name for their activities or a combination of ING and their local name. In the coming years, having one brand will be regarded as a critical success factor in the financial world and will also enable ING to realise significant synergy opportunities while building global name awareness", said Ewald Kist, chairman of the Executive Board.[20]

4.2 Strategy towards 2005

The *mission* of ING is to be a leading, global, client-focused, innovative and low-cost provider of financial services through the distribution channels of the client's preference in markets where ING can create value.

The Group has the following strategic objectives till 2005:

- *Strengthen the capital base and improve other key ratios to maintain a solid financial foundation.*

- *Optimise the existing portfolio:* ING will focus more in terms of activities it wishes to expand or scale down and in terms of markets it wants to be in or withdraw from. No large acquisitions will be made in the near future. In markets where reinforcement of the distribution capacity is an immediate priority, ING will seek to enter into joint ventures with local partners.
  ING will be very selective about investment choices and deployment of resources. In this connection, the Executive Board is reviewing the countries in which ING is active, the business lines and the client base.
- *Create value for the clients with multi-product/multi-channel approach:* From the start, ING has chosen integrated financial services as the heart of its strategy. The power of the integrated financial services concept is in the multi-channel/multi-product approach. Clients appreciate a full range of products and they expect to be served via the distribution channel of their choice. That choice may depend on the type of product: the internet for simple products such as savings deposits, a call centre for applying for an insurance policy or a credit card and a professional intermediary for advice on a tailor-made retirement plan.
- *Develop ING's special skills:* With five million clients and € 55 billion in funds entrusted at the end of 2002, ING Direct proves to be a significant value creator. The ING Direct operations in seven large countries have thus created substantial value for ING in only a few years' time. ING Direct meanwhile also contributes to profit, with an attractive risk-adjusted return on capital. Furthermore, the ING Direct client base offers attractive opportunities for cross selling.
  The same is true for the *insurance operations in developing markets,* which are contributing approximately 20 percent to the total insurance result. In the past few years, the total revenue and the result of these businesses have shown double-digit growth. Most of the embedded value from new insurance business is generated by these operations. The pension funds in a number of developing economies are also rapidly increasing their client base and assets under management. As a *pension specialist,* ING currently offers pension products in 30 countries around the globe and assists governments struggling with the necessary reform of their pension systems. The pension business also offers attractive opportunities for cross selling.
- *Further lower the cost base:* In 2002, ING made much progress in lowering its cost base. The strict cost discipline will be maintained in the years ahead. Substantial future cost savings are expected from the rationalisation of the operations/IT activities. ING will continue to invest approximately € 1.1 billion in the shared service centres until

2005, while the total cost savings of integrating these back-office activities will amount to about € 2.7 billion.This is equal to 5 percent of total operational expenses.

5. STRATEGY TOWARDS CEE

5.1 Market presence

The strategy of entering the emerging markets[21] is in fact a direct realisation of the focus strategy of ING. The reason to become active in the emerging markets was, according one ING executive: "that in those countries specialised banks were needed and moreover had the highest growth rates". In the 1980s, the bank started building up a network in Latin America. In a few years time, the former NMB, has become one of the largest players in the market of secondary debt of Latin American countries. In the process, ING also acquired the necessary know-how to deal with governments and financial markets in turbulent countries. This inspired the Board of Directors to expand the presence of ING to other emerging markets in the world.

Two issues in relation to the emerging markets are very important for ING:

a) Though ING Bank is present in many places of the world, it has to be emphasised that it is not the purpose of ING Bank to serve all their customers everywhere. ING Bank is not, like Citibank, a retail bank outside the Netherlands. While serving corporate customers, ING Bank gradually initiates life insurance activities.
b) When a country opens its borders for foreign banks, ING considers it very important to open an office in that country as at least one of the first Western banks.

The Central and Eastern European (CEE) countries were seen as an extension of the emerging markets, which before 1990 used to be Latin America and Southeast Asia. Common features of CEE and Latin America were the high inflation levels and the necessity to act swiftly on opportunities. There was also an important difference between CEE and Latin America. In CEE financial markets were underdeveloped or non-existing. ING could offer rather elementary services like domestic and foreign payments. In Latin America the domestic financial markets were developed. In CEE the quality of basic services was (and in some countries still is) a distinctive competence by itself as long as ING was the first or one of the first Western banks.

This is one of the reasons why ING wants to be the first Western bank present in emerging markets. However, this would not be enough if ING were not able to offer higher-level services. In offering such basic services like payments' services and trade and commodity finance, ING outperforms other banks and has henceforth a foothold in the new market.

In 1995, CEO Jacobs confirmed the commitment to the emerging markets: "... those [emerging markets] are fundamental growth areas of the future. And the amounts you have to put in these countries are large, but are less then you would have to spend to buy a large Western institution in a developed area. The risk-reward ratio is good. We are making history here".[22]

5.2 Branch or subsidiary

ING Bank Vienna was the entry point for ING into the CEE markets. It offered products to these countries where ING did not have (or not yet) a presence (the so called 'non-presence' countries). It was also supporting ING branches in countries where ING was present. However, for the 'non-presence' countries a wider range of products was offered. An example is the CEAL (Central European Agency Line) agreement[23] with the EBRD (European Bank for Reconstruction and Development). ING Vienna acted as ING agent for the CEE region (except for Poland).

Three reasons support the decision of ING to open an office or take over a local company:

1. *ING clients are doing business in these countries:* Whether private persons, small or medium enterprises or large multinationals, an intensified trade or investment traffic with a 'non-presence' country will motivate ING to open an office there in order to better satisfy the needs of the clients;
2. *Strategic interests:* Part of the strategy is to open offices as the first Western bank;
3. *One off opportunity:* In some cases, there is a "now or never" opportunity to take over or to participate in a local bank, e.g. Bank Slaski in Poland or the Dunabank in Hungary. However, these investments would have been more difficult to make if ING Bank did not have had a presence in these countries for some years.

There are several advantages of opening an office as one of the first Western banks in CEE:

- Market tariffs are not dictating;[24]
- The incentive for foreign companies doing business in CEE to use the services of ING;
- The reputation of ING in CEE because ING is the first Western bank;

- The relatively few problems related to the negotiations with the CEE central banks[25] to open an office.

These advantages imply that ING has a unique advantage when they are first. The profits are high and the pay back period is very short. For instance, ING Moscow expected to be profitable within two years after the establishment.[26] As of April 1996, all bank branches in CEE have become profitable within two years.[27]

The sequence in which ING opens offices in several countries depends mainly on the market potential. At the same time, entering a country can be provoked by the behaviour of a competitor. Such is the case of the ING branch in Sofia. At the end of 1993, a tiny rumour spread in the banking world. According to this rumour ABN AMRO considered to open an office in the capital of Bulgaria, Sofia. The Board of Directors of ING did not hesitate long. In a very short time two experienced bank managers were assigned to establish ING Bank in Sofia and they had to leave their offices in Warsaw respectively Prague immediately. In May 1994 these bankers arrived 'with a pencil and a suitcase'. ING obtained a full licence to operate on 16 June 1994 and ING Sofia's operations started 3 October 1994. The official opening of the office was 12 January 1995. The importance of the opening of ING in Bulgaria is expressed by Cees Maas, member of the executive Board of Directors of ING Group at that time: 'We did not have hesitations [for entering the Bulgarian market], it is a matter of priority. Poland, for example, is a much bigger country than yours [Bulgaria]. And it is logical to start in those countries where we have a bigger client base, where investors work. Our clients went first to Poland and after that, to the Czech Republic and Hungary. It is all practical businesses".[28] This statement is in line with the most important properties that determine in which sequence 'non-presence' countries become 'presence' countries:

- *Emerging market:* An emerging market with good prospects on economic growth. There should be signals like growing gross domestic product, legislation, and political attitude, from the country that indicates a good prospect.
- *Financial markets in the country* are clearly imperfect. There is a real need for sophisticated services in imperfect markets, thus higher margins can be attained.
- *Multinationals are interested in the country:* a crucial determinant whether multinationals come to invest in the country in addition to the economic growth prospects. Profits do not depend on margins only but also on volumes that are defined by the size of the market.
- *One-off opportunities* to take over a strong local bank that provides an immediate captive market.

In accordance with the above properties the countries of Central Europe (e.g. Poland, Hungary, the Czech Republic and Slovakia) have clearly being the first to attract the attention of ING.

The first step in establishing a branch or subsidiary is to choose the country in which this office will be resided. Although ING is part of the ING Group, when the Regional Support Foreign Branches and Subsidiaries Departments make a proposal to open a new office, the factors that determine the profitability for the insurance part of the group are in the first place not taken into account. This is due to the nature of the business: banking is a wholesale business while insurance is a retail business. When the managing directors of ING Bank International also approve the proposal, the Board of Directors of the ING Group makes the final decision.

A precise definition of the entry dates of ING in a number of CEE countries is difficult to give because several criteria can be used. However, it is obvious from the following table (see Table 7-3) that ING aimed first at the Visegrad countries[29] , the countries that have shown most progress in economic terms, and after that the second group of countries like Russia, Ukraine, Romania and Bulgaria.

Table 7-3. ING in Central and Eastern Europe

Presence Countries	Name of office	Establishment of branch/ subsidiary*
Austria	ING Bank Vienna	January 1991
Hungary	ING Bank Budapest	1991
Poland	ING Bank Warsaw	August 1991
Czech Republic	ING Bank Prague (**)	October 1993
Slovak Republic	ING Bank Bratislava (***)	October1993
Russia	ING Bank Moscow (Eurasia)	March 1994
Ukraine	ING Bank Kiev	1994
Romania	ING Bank Bucharest	1994
Bulgaria	ING Bank Sofia	January. 1994

Source: ING Bank, Amsterdam and its foreign affiliates

Notes: * The dates/years of the establishment are determined by the granting of a full licence by the respective authorities. In some cases the Bank was already operational: it is carrying out normal banking operations instead of only having a representative office.

** ING Bank started its commercial activities in March 1992 as ING Bank (CSFR) A.S., a subsidiary of ING Bank N.V. with offices in Prague and Bratislava.

***ING Bank Bratislava started as a rep office during the time of Czechoslovakia. ING Bank Bratislava became a branch in January 1992. The commercial activities started in March 1992. After the split of Czechoslovakia, the branch got a full banking licence from the National Bank of Slovakia on 26 February 1993. The development of the activities of ING in Bratislava necessitated a further change and ING became a full branch on October 1, 1993.

However, this strategy of opening offices does not imply that an analysis is ignored. With the features of a country known or assumed, the Foreign

Branches and Subsidiaries Department carries out a feasibility study. In this study, a cost-revenue analysis is made. The costs and the revenues depend on the following (also country dependant) factors:

a) *Which products are offered:* Each product carries certain costs and generates revenues. These costs and revenues differ per product and per country while it is also possible that the supply of a certain product has impacts on the same product in a different country;
b) *The level of the local banking standards:* For example, if the local banks are very slow with payments, ING has a competitive advantage because they are much quicker. If the banking system is less developed, the margins tend to be more attractive.

There is an important difference between branches, subsidiaries and representative offices. Subsidiaries of a foreign bank are subject to the same regulations as local banks but they are not subject to the regulations of the parent bank's country. A foreign branch is an office of the home bank in another country and is usually subjected to local and home banking regulations. However, branches can often take an advantage from cross-border regulatory differences. When ING considers opening an office it starts with a representative office (rep office) in order to survey the local market. However, as activities of the office expand, a branch or a subsidiary is necessary to meet the client's wishes: a rep office cannot carry out transactions.

The main strategy for opening a branch, a subsidiary or a rep office in CEE does in principle not differ from the strategy in other emerging markets. Thus ING applies the same criteria, whether it is an office in CEE or, e.g. an office in a South East Asian country.

Despite the fact that the strategy for opening a branch or subsidiary is the same, a branch is always preferred to a subsidiary. This is because a subsidiary generates more costs and a branch offers more possibilities. A subsidiary is a separate legal entity while a branch is an integral part of ING Bank. Being part of ING Bank itself avoids the need of a starting capital as required by national and international regulations. Second, a board of directors has to be installed. Third, the amount of money that can be lent is restricted.[30] These requirements and restrictions are expensive and do not add value to ING.

The only (though doubtful) advantage of a subsidiary could be that in case of bankruptcy of a subsidiary, a subsidiary cannot affect the Group, as it is a separate legal entity. This argument has little weight in practice. If a subsidiary runs into trouble, ING cannot afford to let it go bankrupt because (apart from juridical difficulties) this would seriously damage its image. All this implies that a subsidiary is only opened if it is not allowed to open a branch and that apparently was the case in Moscow and in Budapest.

Opening a rep office is a different matter. When the prospects are too uncertain and the risks too high for opening a branch or a subsidiary one very often chooses for a rep office. This gives an opportunity to obtain expertise and to move quickly when the circumstances alter.

The time required for the entire investment process, starting with the decision whether or not to open an office, obtaining a licence, finding accommodation, recruiting staff and finally open the office, depends on several factors. These factors comprise the governmental co-operation (which is usually ample), the human resources of ING (which may become a problem when too many offices are established at the same time) and (sometimes) the availability of suitable office space. The average time between the granting of a banking license and the operation of an office is about six months.

In 1995, ING already had fully owned banking subsidiaries in Budapest and Moscow and branches in Prague, Warsaw, Bratislava, Bucharest, Sofia, rep offices in Brno, Liberec (Czech Republic), Kosice (Slovakia), Gdansk (Poland) and Kiev (Ukraine), and equity stakes in the Polish Bank Slaski. Next, ING acquired the activities of the Hungarian Dunabank[31]. The operations in the emerging markets were supervised by one of the following organisational centres: ING Financial Services International or ING Corporate & Investment Banking.

The commitment to and the expertise in almost all countries of CEE have created an international reputation for ING as an innovative bank. Though the authoritative magazine Euromoney has been regarding ING as the best bank in CEE, the same magazine considers ING's rival Citibank as the leading bank in emerging markets. Citibank is present in 94 countries and has an extended network of offices in CEE. Though Citibank has a considerable advantage in the emerging markets, ING Group has shown in CEE that with the combination of commitment and innovation a smaller bank is in the position to become the most important player in emerging markets.[32]

6. CONCLUSIONS

The eastward expansion of international banking has mainly involved financial groups of a medium size. Exceptions are Citigroup, Allianz (mainly with insurance) and ING Group (see Figure 7-2). The banks present in Central and Eastern Europe are mostly of European origin. The main driving forces for these banks to invest in the region are:

1. Opportunities for growth and further consolidation through takeovers and acquisition that provides them a more solid European wide base.

2. Expansion into new markets where the competition of local banks is negligent and where large multinationals and viable domestic firms look for reliable banks.
3. Financial activities in the region offer better margins than in Western Europe provided that risks and opportunities are well balanced.

Figure 7-2. World leading financial groups[33]

The market for financial services in CEE needs another 10 to 20 years to mature to Western levels. Until then, international financial groups will set the agenda as far as products, standards and way of banking in general are concerned. This definitely gives them the possibility to get the best the market can provide. The competition between banks in the region has increased in the late 1990s due to a rapid entrance of more international banks through privatisation deals. This forces them to consolidate on national levels. A consolidation process is also taking place internationally. As a result of the two trends many international banks have currently a dominant market position in Central and Eastern Europe. The consolidation of banks in CEE will most probably continue since the number of banks is still too high. The state in these countries will proceed with the privatisation of what is left from the public financial sector. In a decade from now we may expect that the financial services in CEE countries will be offered primarily by a handful number of banks with prevailing foreign ownership, mainly of European origin.

The first products to be offered to the CEE market were the traditional banking services but at a higher quality level. With the development of the market and its demand in terms of quality, international financial groups launched more sophisticated products that go beyond retail and wholesale banking. Insurance is one of them. Groups that already were present in the market and at the same time had insurance in their portfolio, like ING Group, expanded into the insurance business. Companies such as Allianz (Germany's largest insurer, **9th** in the ranking of financial institutions for 2001, see Figure 2), invested in Hungary, the Czech Republic, Poland, Romania, Slovakia, Bulgaria, and in Croatia towards the end of the 1990s. It is the biggest foreign insurer in the region (7% market share), number one in Hungary, number two in Bulgaria and number three in Romania. The strategic goal of Allianz is to be among the top five in each country. The positive experience from investment in Eastern Germany in 1990 pushed Allianz eastward with the following investment determinants in mind:[34]

- Long-term approach realising the Central and Eastern European market has a great growth potential;
- Enter Poland as a priority country because of the market size. Allianz was too late in this market and has only 2.5 percent of the market share);
- Link up with a local bank (when possible) in every country and build a broad-based agent network;
- Use the experience to go further to Russia and Baltic states as well as Uzbekistan and Kazakhstan.

The global strategy of ING Group is based on their Model of Adjustment. A result from this strategy is the focus strategy. One of the markets on which ING is focused are the emerging markets. ING has committed itself to a large extent to emerging markets in general and to CEE in particular. As a result, it has become one of the best-known banks in the region. This commitment resulted in a physical presence in most countries of the region. The eastward expansion of ING was performed in steps. ING opened offices in a sequence based on priorities and local circumstances, with emphasis on the merit of being first. ING's first priority was to serve the multinational clients, most of them clients of ING in its traditional markets. Soon after ING could get a closer understanding of local business, it attracted into its client base large and financially reliable domestic companies. ING was first in many fields and it took considerable advantages from this approach. In Bulgaria, for instance, it could dominate the transactions with Brady Bonds during the privatisation process.

In view of ING's strategy towards 2005, we may expect that the following actions of the Group will take place in CEE:

- Consolidation of the bank's equity participations in order to optimise its capital base;
- Optimisation of the product portfolio shifting from traditional banking to more sophisticated financial products, including insurance;
- Involving CEE in the bank's strive for lower costs European wide by placing some of the support activities in low costs countries.[35]

NOTES

[1] After the chaos: A survey of finance in Central Europe, The Economist, September 14th, 2002

[2] Fragmented sector begins to consolidate, Financial Times, July 2, 2001

[3] Foreign presence proves controversial, FT, April 17, 2000

[4] International banks ready to claim east European prizes, Financial Times, 20 October 2001

[5] Ibid

[6] Fragmented sector begins to consolidate, Financial Times, July 2, 2001

[7] Source: Fragmented sector begins to consolidate, Financial Times, July 2, 2001; After the chaos: A survey of finance in Central Europe, The Economist, September 14th, 2002; ABN AMRO takes over Polish bank for $10 m, Financial Times, 23 December 1994;

[8] International banks ready to claim east European prizes, Financial Times, 20 October 2001

[9] Foreign presence proves controversial, FT, April 17, 2000

[10] International banks ready to claim east European prizes, Financial Times, 20 October 2001

[11] Based on: International banks ready to claim east European prizes, Financial Times, 20 October 2001

[12] ING Groep web presentation 2003

[13] Corporate advertisement of ING Group in the Financial Times, 6 February 1991

[14] Bancassurance is a concept that means the integration of a bank and insurance company in order to gain advantages in the financial services. Bancassurance is a well-known concept in continental Europe, in contrary to the Anglo-Saxon world where even the commercial banking operations are separated from the investment banking operations.

[15] Graham and Van de Krol, Respectable ING reaps rewards of a little daring, Financial Times, 4 January 1996.

[16] This is the famous strategy of Michael Porter, who taught us that a company might obtain a competitive advantage if the company focuses specifically on the demands of a segment of the market. Because of the specialisation, the company can reach an economy of scale that is impossible to copy for a general company. Other strategies include a differential advantage and a lower cost strategy.

[17] Bakker, T., Schaken voor de bank, FEM, no. 15, 8th of July 1995

[18] Rijnen, H., De verleidelijke City, FEM, no. 23, 12th of November 1994.

[19] ING progresses towards one worldwide brand, Press release, Amsterdam, 23 November 2001

[20] Ibid

[21] An emerging market is defined as a non-OECD country with high prospects of economic growth. The emerging markets are in Latin America, Middle and Far East and CEE, including the New Independent States (NIS).

[22] Flying Dutchman, Why Aad Jacobs decided Holland's ING would buy Barings, FW, June 20, 1995

[23] Investment project that comply with the requirements of the ING can approach ING Vienna. ING alleviates the political risk involved in the project through co-financing.

Therefore, ING has concluded a co-financing arrangement with the EBRD. This co-operation is legally formed in the CEAL agreement.

[24] This reason was mentioned by Maarten Pronk, General Manager of ING Bank Moscow, in the FEM, no. 24, 26th of November, 1994

[25] In relation with the Dutch central bank who supervises activities of all Dutch banks, there is no problem related to opening a branch or subsidiary in CEE countries because the ING Bank is not or not in the first place granting credits to CEE companies. In that case, the regulations of the DNB regarding the country risks are applicable.

[26] Jansen, G., Dansen op de vulkaan, FEM, no. 24, 26th of November, 1994

[27] According to ING Group's public relation department.

[28] Christova, C., ING Bank Sofia can match parties, Balkan News International, May 7, 1995

[29] The Visegrad countries are Poland, Hungary and the Czech and Slovak Republic.

[30] An example will clarify this advantage of the branch. Because of solvability requirements of central banks and the Bank for International Settlements, the banks are restricted in lending money. Suppose that the ratio equity/balance sheet total should be at least 8%. A subsidiary in which Dfl 100 million capital is put, can lend up to (1/.08)100 million = 1,250 billion guilders. A branch is part of the ING Group and has therefore an equity base of more then 20 billion guilders!

[31] Annual Report 1995, ING Group 1996.

[32] Awards of Excellence, Euromoney, July 1995

[33] ING Group web presentation 2003

[34] Adapted from Financial Times, March 12, 2001

[35] ING is presently outsourcing IT-projects to India and intends to continue doing this. (Source: ING Group web presentation 2003)

Chapter 8

Unilever Group

1. INTRODUCTION

The Unilever Group was established when Dutch Margarine Unie and UK Lever Brothers merged in 1930. Unilever N.V. and Unilever PLC, as they are now known, are the parent companies of what is today one of the largest consumer goods businesses in the world, with its corporate centres located in London and Rotterdam.

Unilever's business in packed food and drinks has developed from its original base in edible fats, established in the Netherlands nearly 125 years ago by Simon van der Bergh and Anton Jurgens. More than one hundred years ago William Hesketh Lever opened his first factory in the UK and launched the famous Sunlight soap brand. From its origin in the early 18th century when famous brand names like Atkinsons and Pears were first introduced in the UK, Unilever's personal products business has developed to become a diverse and internationally successful world leader.

The greater part of Unilever's business is in branded and packaged goods, primarily: food, home and personal care products. Its market capitalisation and turnover show it is positioned amongst the top industrial producers in the world. Unilever ranks 41 on the Financial Times Global 500 list in 2003 (up from 62 in 2002). It is the second largest food producer and processor after Nestle.[1]

Unilever has continued to develop its range of products and its organisational structure along a broad vertical integration: "from the palm tree to the soap-kettle".[2] "It is easy to forget how diverse our activities were only 10 years ago. We were in transport, distribution, market research,

advertising, fishing, printing, plastics and packaging - you name it, Unilever had tried it".[3] In the early 1980s, most of those businesses - accounting for nearly a quarter of the group's sales - were sold off to obtain a narrower business focus and an increase in average operating margins.

Unilever achieved a turnover of about € 50 billion at the end of the 20th century, 1.5 times higher than in the beginning of the 1990s.[4] It has reached a market capitalisation of approximately € 60 billion The company had approximately 300 subsidiaries with total of 270 000 employees in 88 countries, marketing close to 1 800 different brands.[5]

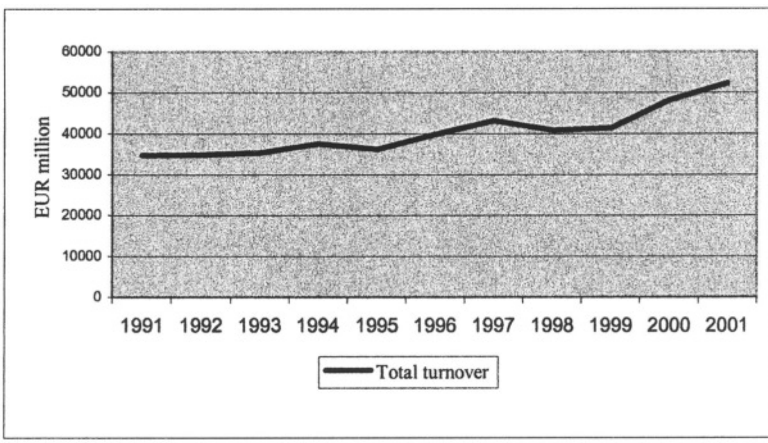

Figure 8-1. **Unilever's turnover in the last decade of the 20th century**

The desire to be an international company is demonstrated in the early years of existence of Unilever when close to 20 percent of the revenues came from outside Europe. In the 1990s non-European revenues accounted for approximately 54 percent of the revenues and 49 percent of the profit of the company.[6] For Unilever, the 21st century begun with an ambitious action programme based on the so-called Path for Growth Strategy. The main elements of this programme are:

- Fewer, stronger brands: concentrate on 400 leading brands;
- E-business: develop e-business models to interact directly with consumers;
- Plant rationalisation at regional level: focussed procurement and manufacturing base – a network of some 150 key manufacturing sites;
- Overall simplification: re-engineering of management services.[7]

"We see our future in a portfolio of strong brands with international and local scale" is the statement of N. FitzGerald, Chairman of Unilever, made by the launching of the Path for Growth Strategy.[8]

2. UNILEVER'S PRODUCT MIX AND MARKETS

Unilever's core product mix consists of foods, home care and professional cleaning as well as personal care products, which amount to about 90 percent of total turnover and about 89 percent of operational profit (see Table 8-1).

Table 8-1. Turnover and operational profit by operation, 2002

Core operation	Turnover*	Operational profit*
Foods:	**27 390**	**2 268**
Savoury and dressings	9 503	450
Spreads and cooking products	6 216	812
Health & wellness and beverages	4 215	390
Ice cream and frozen foods	7 456	616
Home & Personal Care:	**20 824**	**2 816**
Home care and professional cleaning	8 579	754
Personal care	12 245	2 062

Source: Unilever Annual Report & Accounts 2002
* In € millions at 2002 rates

Particularly in the food business, where the three giants, Nestlé, Unilever, and Danone, dominate in Europe, good profits depend mainly on boosting sales volume and expanding market share. Lately two major trends in the industry have limited the growth options for the producers. These were: the strengthening of the retailers' position and cost-conscious consumers with flat incomes. With raw material costs beginning to rise, there was severe pressure on margins combined with a need for maintaining low selling prices. In these conditions competitors strived for cheap production with peak efficiency in their factories, as well as innovation and clever marketing. As a reaction, two types of actions were typical for the global players in the sector: the closing down of factories and portfolio restructuring. Portfolio restructuring limits the competition to large-scale production in fewer strong brands and products while freeing capital to invest in new markets.

Unilever has always had a clear priority in foods, a product group that provides more than half the company's turnover. It also maintained its interest in home care and professional cleaning products that account for about one fourth of the turnover. Obvious changes can be observed in the product groups "personal care" and "speciality chemicals". The former was placed in the focus of the company, tripling its share of the total turnover in the period 1991-2001. The latter has been disposed from Unilever's product mix as of 1998 (see Figure 8-2).[9]

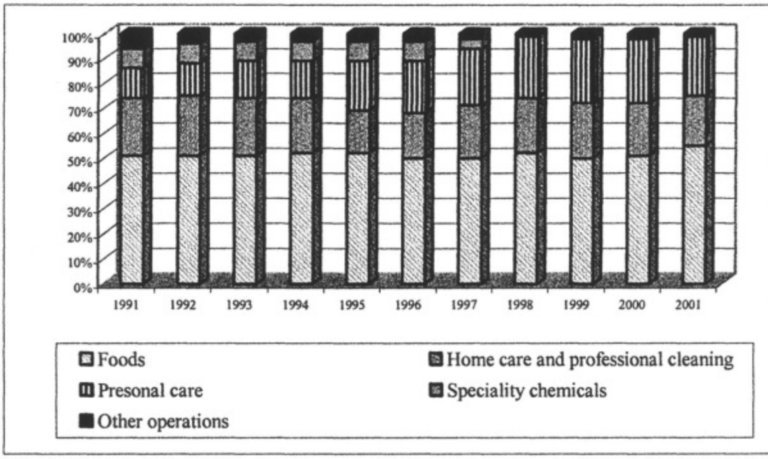

Figure 8-2. Turnover by product groups for the period 1991-2001 (as % of total)

As part of its restructuring programme, Unilever acquired some 64 food businesses and disposed of 28 others over the years 1992-1996.[10] Of the purchased businesses, 18 were ice cream- and 8 were margarine producers. In 1997 the number of acquisitions was 23, most of them in ice cream, some in tea, detergents and yellow fats (margarine). There were 18 disinvestments in that year (excluding speciality chemicals), most of them in peripheral activities. In 1999 Unilever made a further 27 acquisitions and disposed of 23 businesses. The main acquisitions were in the emerging markets of Asia and Latin America while the disposed businesses were mainly in West Europe.[11]

Unilever was reorganising its Western European and North American operations and it invested in developing and emerging markets. In 1996 these new markets generated around US$ 7.1 billion, or twice the figure for 1992 and around 26 percent of the total turnover.[12] "The greater part of our future growth is likely to come from regions outside Europe and North America", stated the 1994 Annual Review. Within its core businesses Unilever identified 12 market categories as strategic markets and it subsequently attempted to focus on the global expansion of these categories to regions the company considered offering potential for growth. With regard to emerging markets, the main focus was on entry or on achieving high growth in targeted sub-regions through further penetration of the market. Unilever identified five emerging sub-regions to be the target of increased penetration: Southern Latin America, Central and Eastern Europe, India, China and South East Asia. Unilever's commitment to emerging markets can be clearly seen from the company's share of investment into

these regions. This share has grown from 16 percent in 1985 to 27 percent in 1996.[13]

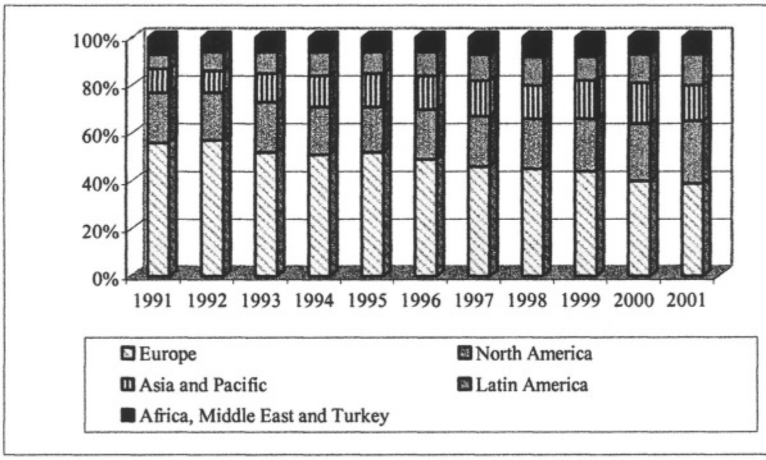

Figure 8-3. Turnover by regions in the period 1991-2001 (as % of total)

The traditional markets of Unilever were Europe and North America, especially in the food business. From close to 80 percent of total company's turnover, these two regions account now for about 60 percent. As of the beginning of the 1990s, the attention of Unilever within Europe was primarily focussed on Central and Eastern Europe.[14]

The priority regions for Unilever, Central and Eastern Europe, Asia and Latin America represent at present about 35 percent of turnover and more than 30 percent of operating profit with a tendency towards steady growth (see Table 8-2).

Table 8-2. Turnover and operating profit by regions, 2002

Geographical area	Turnover*	Operating profit
Europe	19 657	1 772
North America	12 568	1 467
Africa, Middle East and Turkey	3 225	295
Asia and Pacific	7 865	1 098
Latin America	5 445	493

Source: Unilever Annual Report & Accounts 2002
* In € million at 2002 rates

There are three priority foods for Unilever which represent more than half the food's turnover and profit: margarine, very much a commodity, and ice cream and tea belonging to impulse products. In all three products Unilever is the world's leading producer.

Although located on two different sides of the market (commodity market and impulse products market), Unilever approaches its three product groups with a common policy - new product development. Unilever's share of the American market for instance has grown from 10 percent in the 1980's to 45 percent in mid-1990s, mainly because of new products based on a new formula - low fat and cholesterol reducing spreads.[15] Unilever spends about 2.5 percent of its annual turnover on research and development. As many as 9000 people are involved in R&D in six major laboratories and in 68 innovation centres that feed market research and ideas into the research laboratories. Unilever has still to master the bridging of scientists, marketers and business managers. "Unilever has stronger basic science than Nestlé, but it is less good in exploiting it,"[16] is the opinion of Andrew Smith, ABN AMRO Hoare Govett.

While innovations in the product portfolio are of great importance to the developed markets, the company's approach into Central and Eastern Europe is based on the expansion of well-established worldwide brands. The Rama margarine brand for instance was the number one brand in Russia and in several other Central European countries.

Fabric cleaning and conditioning products is the largest product group in the home care and professional cleaning business. 1997 was the first full year of operation of Diversey Lever which was the result of a merger in 1996 and which is now one of the leading professional cleaning companies in the world. The Western market is a difficult one for Unilever's detergents. The overall market position of Unilever in fabric cleaners was weakened in mid-1990s when sales went down by as much as 13 percent. Cost saving and market support measures were introduced that allowed the operating profits to grow as of 1997. In these products Unilever tries to maintain its market share not expecting much sales growth. At the same time emerging markets have shown steady progress in increasing the volume and the operating profit of these product categories. Similarly to food products, markets outside of Western Europe and North America offer growth opportunities for the company. For example sales in developing and emerging markets represented almost half of Unilever's worldwide sales of detergents in mid-1990s.[17]

In the home and personal care sector, Unilever's brands continue to grow and the company is a market leader in many counties. In home care products Unilever is focusing on priority brands and markets while improving the profitability of the portfolio as a whole. To be successful in the personal products sector requires sustained and effective innovation in the market place, presenting the consumer a continuing and relevant range of choices to meet his or her personal grooming needs. Through innovation and range extension in Dove, Rexona and Axe, for instance, Unilever could ensure

sales growth in Western Europe in the last years. In Central and Eastern Europe the product group of home and personal care shows a steady growth and contributes substantially to the sales growth of 9 percent for the region in 2002.[18]

2.1 The multi-local multinational

The product-market policy of Unilever is based on a concept of "getting it right" that means: the right product for the right market. In the business of food, home and personal care products it is important to know individual consumer trends in different markets and adapt the product concept accordingly. One should have "the sensitivity to know when a global brand makes sense or when local requirements should take precedence... when to transfer innovation and expertise from one market to another and, equally, when a local idea has global potential... when to bring international teams together fast to focus on key opportunities."[19] While Unilever often approaches stagnant markets with innovations and new formula products, emerging markets are approached with worldwide brands and quality improvements of existing local brands. Correctly chosen product-market combinations should provide a high level of performance in developing markets that is able to compensate for declines in the saturated markets. For instance, the decline in the volumes of Unilever's West European markets in 1995 was partly compensated by the continued growth in Central and Eastern Europe.

3. ORGANISATIONAL AND DECISION-MAKING STRUCTURE

From 1960 to 1995 Unilever operated under a matrix organisational structure distinguished by product groups and geographical regions. Like many other multinational companies, Unilever has attempted to change the balance between decentralisation and centralisation in its organisational and decision making structure over the years, as a response to global trends in the industry and the markets. In the matrix structure the company combined high operational and restricted strategic decentralisation. In search of a simpler and more effective organisational structure, Unilever introduced a series of top-level changes in March 1996 and in 2000. The changes aimed at a clearer allocation of responsibility for corporate strategic leadership and operational execution, strong regional focus within a framework of agreed category strategies and operational decision-making close to the market.[20] Following their Path for Growth Strategy, Unilever decided to introduce two

global divisions, Food respectively Home and Personal Care. This structure allows improved focus on the main product groups at both regional and global level. More efficient decision-making and effectively integrated research into the divisional level are the other reasons for the present organisational structure of the company.

Unilever has two levels of management: an Executive Committee, responsible for corporate strategic leadership and Business Group Presidents, who are responsible for operational management. All operating units are organised into twelve Business Groups. The two levels of management together form the Unilever Executive Council (UEC) that acts as the principle discussion forum on policy matters.

The Executive Committee is responsible for:

- Setting overall corporate targets, defining the role of each Business Group and agreeing on priorities and corporate resource allocation;
- Agreeing and monitoring Business Group strategies and annual plans;
- Identifying and exploiting those areas of opportunity where Unilever's scale and scope can add significant value;
- Managing relations with the external world at corporate level;
- Identifying and overseeing the careers of the future leaders of Unilever.

The Business Group Presidents are responsible for:

- The profit in their group;
- Development of regional strategies and plans to execute corporate strategy;
- The understanding of local market needs, providing input to the development of corporate strategy and for the allocation of corporate resources;
- The representation of Unilever in their region;
- Specific corporate issues.

The Business Group Presidents have management responsibility for the operating companies that belong to their groups. Unilever has over 120 operating companies worldwide.

Traditionally, Unilever first establishes a national organisation in the country it decides to enter. The function of this national organisation changes over time, depending on the investment opportunities in the area. In most cases, national organisations start as an import organisation. These import units are the front-runners of the market development that follows and therefore they have more than a trade attitude towards the region/country. Their intervention is meant for on-going opening of new market opportunities. Their next job is to study market potential, its specific needs and its consumer behaviour. In addition to this, they search for potential joint venture or acquisition partners. When operational companies

are being established in the country, they report to the manager of Unilever's national organisation. With respect to CEE, there are national managers for Poland, Hungary, the Czech Republic, the Slovak Republic, Russia, Romania, Bulgaria, Croatia, the Ukraine, the Baltic states and Kazakhstan.

After an acquisition has been made in CEE, national management becomes responsible for the operations in the country. Its responsibilities concern both market and profit. The next step is to send Unilever's staff to help start up the operations. Unilever's staff is required mainly in marketing, sales and the organisation of production. Expatriate staff is needed until local experts are able to take over these functions. Unilever applies the formula "put locals in charge." Before this formula can begin to work, one of the main tasks of Unilever's expatriate staff is to transfer knowledge and to train local experts. In 1997 Unilever delivered over 70 000 man-days of training to its employees in Central and Eastern Europe.

4. THE DECISION-MAKING PROCESS IN CEE

The Executive Committee sets up the global strategy of Unilever using the top-down and bottom-up approach. The same applies to the general framework strategy towards CEE. The company has historical links with some of the countries in the region dating back to the 1930s when Unilever was present in Hungary, Czechoslovakia and Poland through its Austrian subsidiary. Unilever Trading B.V. maintained only limited trading operations after the socialist revolutions in these countries. It was only after the fall of the Berlin Wall, that the region of CEE was brought into new strategic consideration. The positive decision of the Executive Committee to start up investigations into possible investments in CEE opened up the fully-fledged activities of the company in this region.

"To expand where the market is" is the philosophy of Unilever. In this respect CEE offers a large market, consumer habits close to Western patterns, low disposable income at the moment, but with substantial growth potential. Global players like Unilever usually enter this kind of market in the early stages of their development.

After the principal decision to enter CEE had been taken, investigations into the region took place, in order to define prime sub-regions. As a result the Central European countries of (then) Czechoslovakia, Hungary and Poland, were identified as priority sub-regions. With regard to selection criteria, the attractiveness of a country is defined in terms of: political stability, business environment (availability of proper banking, auditing, accounting, etc.), legal environment, privatisation, the government's attitude towards market reforms and the maturity of macro-economic policy. In

addition to the attractiveness of the country, an important criterion for investment is the market potential.

The CEE Business Group, that was part of the organisational structure until 2000, was responsible for feasibility studies of the region and the countries in it. The feasibility studies are based on a checklist, developed by this Group. This checklist has been continuously improved and updated on the basis of experience gained in the region. Although CEE was a new region with specific characteristics, experience in other regions such as Latin America and Asia served as a source for the CEE checklist as well as for the further operations in the region (for instance, experience gained in how to operate under hyperinflation, unstructured distribution system, etc.).

The CEE Business Group checked its vision on company's strategy towards CEE with other Business Groups. The latter have information from all over the world concerning consumers and their behaviour, the perception of the products produced by Unilever, their ways of marketing and distribution. Similarities between regions and countries can be found in issues such as market approach, sales, distribution and marketing strategy and were used in the approach towards the new markets of CEE.

Functional Services (FS) were approached for confirmation on matters such as the fiscal, legal and financial situations in the countries of CEE. The experts of the FS departments follow developments in all regions.

The Executive Committee acted as a sounding board for specific strategies towards CEE forwarded by the CEE Business Group. This is the level where regional and country strategies are checked to determine whether they match the global strategy of the company as well as the general framework strategy for CEE.

After the desk research has been finalised, a fact-finding mission (it may already be an acquisition mission) is organised. In order to undertake the investigation, experts from the FS department and the other Business Groups supported the experts of the CEE Business Group.

There are some external sources of information that are used to support the desk research. Such sources are EIU[21] country report forecasts as well as other international publications; the experience of lawyers and accounting consultants for example all contribute to the process.

The contribution of local experts is important and can be considerable in the feasibility phase. Usually Unilever's national organisation helps, but before it is established, local experts may be needed. At the same time one should bear in mind that the use of local specialists can be quite difficult for several reasons: misunderstanding on the terms of reference, difficulties in executing control over their performance from a distance, a different way of thinking and the quality of work.

5. GLOBAL CORPORATE STRATEGY AND STRATEGIES TOWARDS CEE COUNTRIES

The ambition of Unilever to maintain its status as a global player represents the core part of its corporate strategy. To be a global player means to compete in the main markets. At the same time one should monitor three main indicators: growth, capital efficiency on asset basis and value creation for the shareholders. Global players can create advantages in these three areas. In addition, they can build competitive advantage by transferring competences from one place to another. As a global player, Unilever tries to develop these advantages. To become and to continue as a global player, Unilever diversifies its products and expands into new markets. "Following a major reassessment of corporate strategy, we have increased focus on those product categories and regions that we believe offer the greatest potential for profitable growth. Although investments in newly liberalised economies might involve some increase in risk, we are sure that the greatest risk would be to fail to take the opportunities which are emerging."[22]

Unilever calls itself a "truly multi-local multinational". The highly decentralised organisational structure underlines the multi-local orientation of the company. Elements of the multi-local multinational strategy are:

- Establishing local companies that have substantial independence from the headquarters;
- Adjustment of international brands to local markets;
- Maintaining or developing local brands that reflect specific needs of local consumers or that have a long history.

Unilever believes that truly global opportunities and brands will be uncommon. In line with this belief, the company's flexible multi-local organisation aims at being sensitive to tastes and needs of local consumers. These tastes and needs are accounted locally and globally. Local is the development of the local brands. Local is also the adaptation of the international brands, the so-called brand positioning. Global is the innovation and the deployment of science and technologies for the continuing development of the international brands. Contrary to Unilever's decentralised organisational approach, many of its competitors have implemented a more centralised approach in order to market their brands, and they have achieved success in marketing global brands. This method can provide many advantages such as economies of scale as well as greater brand consistency and brand recognition across the globe. For Unilever the world is not a set of countries, neither is it a global village. To convert this philosophy into a well working strategy means a constant reconsidering of developments and trends at all levels: country's, regional, multi-regional and global.

Unilever's traditional markets (North America and Western Europe) are already mature. To sustain a leadership position in these markets, a firm should concentrate its efforts and diversify within the core business. This was Unilever's vision in the 1970s when the portfolio that the company now calls traditional, had been established along the company's core businesses. Nowadays, mature markets can only be sustained through a high rate of product diversification and introduction of new products. In order to compete successfully on mature markets, global players must choose among four options: to be better than other companies, to buy out their competitors, to establish strategic alliances or to merge.

CEE belongs to the real growth markets where the question to expand or not does not exist. To be there is a "must" strategy for a global player like Unilever. One of the advantages to be gained from being the first in CEE is the potential to build up volume versus existing options. The specialisation of the CEE countries in the CMEA period has left a dominating mono-structure of the industry with a small number of large, highly focused enterprises. Many of them, thanks to special attention received from the governments, were technically in a very good state. Many multinationals moved quickly towards CEE in order to acquire the East European "diamonds". Unilever entered the market as one of the first and with its core businesses. Other companies did the same, e.g. Nestlé with chocolate, Philip Morris with cigarettes and Procter & Gamble with detergents.

Unilever entered CEE for the market and not for cost advantages. It invested in manufacturing and in related activities. For instance, it is well known that the former supply systems of the CEE countries collapsed soon after the changes in the region. In such circumstances suppliers end up with problems such as a lack of money, a backlog in capacities and an upstream supply chain as a bottleneck. It is important for Unilever to sustain the quality that depends very much on continuous supply. In the case of CEE one has the opportunity to have the supply chain oneself and to build up an optimal supply through solving the main obstacles in the upstream/downstream logistics chain.

Unilever always enters a new market with tailor-made marketing for the customer in the new market. It is based on an optimal balance between quality and price, related to disposable income. Perhaps CEE markets resemble those of Western Europe in the 1950s, but it has got the opportunity to go through the learning curve faster than the West.

6. ATTRACTIVENESS OF CEE AS AN INVESTMENT AREA

The traditional attractions of the region, such as a low-cost production base, investment incentives, a skilled labour force and cheap resources, represent only part of the aggregated attractiveness of CEE as an investment area for Unilever. Very often such attractions are only short-term. An example is the importance of productivity versus low labour costs. It is true that CEE companies employ more people than necessary for the turnover they produce, but their salary costs are considerably low. The businesses acquired by Unilever in CEE have grown quickly in a short period of time and the company has even increased employment. The problem is with the productivity level, which is low and which therefore sometimes neutralises the advantages gained from low labour costs. This can be offset, as there is potential for productivity increases especially among the technical aspects in the field of production. There is a lack of experience in marketing, accounting and selling, but the local specialists are catching up fast.

What can be considered as long-term attractions in CEE are its large domestic markets and market potential respectively, its Western-like life styles and capabilities. The macroeconomic indicators, such as inflation, debt, stability of the currency and privatisation for instance are important for a concrete investment decision. In addition, there is a micro-view that may be specific for every company. For Unilever the product point of view is very important: do people in this market eat certain products; do they use this soap or that washing powder; is the market large and so on. The answers will provide the comparative basis to allow Unilever to decide which market is most attractive. It may be the case that a certain market is attractive in general but it is not considered attractive for Unilever in particular. This analysis is a subject matter of the Europe Business Groups (formerly of the CEE Business Group), which identifies different priorities by products and countries.

One very important characteristic of any new market, especially of a consumer market, is the trend in consumer behaviour. Certain logic can be found in the consumer behaviour in CEE. Soon after the borders for inter-trade were opened up, there was a boost in the presence of Western products and companies. They met curious customers for whom Western products were just “dreams”. Soon after, the curiosity was replaced by “can I afford it” behaviour that led to a more careful choice of products and as a result, a slower rate of consumption. Many consumers reverted back to locally produced goods realising that the quality of many domestic products was satisfactory for the price at which they were sold. In the meantime, local manufacturers begun to learn from the international companies and the

international companies adapted their brands and prices. Consequently, consumer confidence was restored.

If one wants to consider what the next move in the market can be, one should analyse past spending patterns as well as the allocation of disposable income and the spending patterns. The presumption was that with market reforms progressing in CEE, disposable income would grow. The reality is that real disposable incomes in most of the countries deteriorated after the mid-1990s. Goods become expensive and the pressure on prime goods increased. Towards the end of the 20th century some of the subsidies on products such as medical help, transport, energy and telecommunications, discontinued. As a result, disposable income decreased further. In the meantime, a real restructuring of the companies took place. This led to a period of frustration for consumers. In order to be able to feel, study and follow the rapid development of the consumer market and behaviour in CEE, one should be present in that market.

There are no CEE countries that are not considered by Unilever as potential markets although countries such as former Yugoslavia in the 1990s and Chechnya might not be on its list of actions. Countries are prioritised in sub-regions. Russia, one of the priority countries, is attractive because of its huge market potential but at the same time it offers high risks and substantial logistics problems. If a new opportunity emerges in a country that is not among the priority areas, it is taken into consideration, but limited resources and limited time are spent on an analysis. If, for instance, export people say there is an option for an acquisition, there will be a follow up discussion before the checklist procedure starts. A team of technical, marketing and other experts will visit the country for approximately two weeks. As a result of the desk and the ground research a decision is taken on how to proceed.

7. INVESTMENT EXPERIENCE IN CEE

Over the past decade Unilever has consistently entered into Central and Eastern Europe with its strong core businesses - foods, detergents and cleaners, and personal products. This entry followed the company's traditional decision making procedure towards emerging markets: setting up the framework goals, feasibility studies in the countries by company experts scouting for potential acquisitions, plant tours and talks with managers.

Specific to Unilever is that it considers every country in the region as a potential investment area. This contrasts with the entry strategy of its main competitor Procter & Gamble, which aims to centralise detergent production for Central and Eastern Europe in one plant in the region. To fulfil this objective, Procter&Gamble acquired a detergent producer in the Czech

Republic in 1991. Such an approach can provide the company with superior scale and efficiency. The approach of Unilever is based on its philosophy to be as close as possible to the customers, to avoid import duties in case of cross-border trading and to build up an image as a contributor to local wealth creation. To answer the question of why Unilever did not save costs by exporting from its Western European plants, the group gave three reasons:[23] to avoid import duties (as much as 40% on margarine in Hungary), which Unilever believed would remain high for some time in order to protect domestic producers; to acquire market share quickly; and finally because most East European countries' external trade positions were too frail to allow large imports. At the same time local production could have been a "risky proposition" if Eastern Europe succeeded in creating a common market, admitted Hans Eggerstedt, Unilever's former director responsible for Europe. In that event, Unilever's factories in the region would step up exports to Western Europe. That would complicate its drive to rationalise surplus West European capacity. But Eggerstedt said there would be no real choice because "even if we didn't export, others would".[24]

Unilever has acquired 11 production units; it has more than 8 000 employees in the region and about 100 expatriates. More than US$ 300 million has been invested in acquisitions, the modernisation of production facilities, the establishment of distribution and sales networks and in education and training of personnel.

7.1 Forms of investment

Unilever, like many other multinationals, prefers the form of majority (mostly 100 percent) shareholding as its primary form of investment, regardless of whether this is through a take-over or a newly established joint venture. In an environment where the legal system is not mature, joint ventures are an unattractive form of investment. It is well known that among the first wave of East-West joint ventures there were a large number of failures. All partners in a joint venture should have the same objectives and the same attitude. CEE partners very often have a short-term attitude towards ownership: they want a quick profit and therefore investments are not a priority (a CEE director knows that he might no longer be a director after a while, so he wants to feel the benefits immediately). A Western partner like Unilever thinks in terms of building up positions and in terms of long-term profits. This necessitates an investment programme; for every global player follow up investment is a "must".

Majority shareholding offers the safeguarding of assets and ownership, fewer internal conflicts and strong management. The majority shareholder can determine his own timing in investments while in joint ventures the

timing has to be matched with the partner. An advantage for the joint venture construction is that it brings local contacts; the full owner must develop these contacts himself.

Greenfield investments offer the advantages of takeovers with a difference in the time needed. One has to go through a bureaucratic procedure often lasting as much as three years. If one buys an existing company one also buys existing experience, markets and technical facilities. However, one almost invariably has to improve logistics, the production process, hygienic conditions and many other aspects.

Comparing the capital basis of the two forms, takeovers require much higher up-front investments than greenfield operations where you pay as you go. One can synchronise the investments with the development of the market. It should be noted that markets in CEE change rapidly and often unexpectedly. When establishing a new factory the market may already have changed when production starts. One might then end up with overcapacity in the case of a takeover.

If a company has to choose between a take-over and a greenfield investment, it should take into account the following controversial elements:

Take-over	*versus*	Greenfield
High chance of old equipment	*versus*	Possibility for new equipment
Limited opportunity for labour selection	*versus*	Opportunity to move to high tech labour
Capacity follows the market	*versus*	Building a capacity
Start up soon after the deal	*versus*	Time lag before start up

Time lag before start up is the real problem of greenfield investments. Sometimes the investor has no choice, as there is not a suitable take-over candidate, or, the opposite, when such a challenging proposition is offered that one cannot refuse it.

Unilever managed to find appropriate take-over cases in Central and Eastern Europe and it has therefore given this form of investment priority. The take-over opportunities in CEE mainly depend on the privatisation of state owned companies that was initiated in all countries of Central Europe at almost the same time. Unilever started with this region first and moved into Eastern Europe alongside the development of the ownership reforms.

Since the take-over form of investment involves, to a large extent, partnership issues, it is important to look at Unilever's CEE partners and analyse aspects such as:

- What are the local company's advantages and disadvantages?
- How local and international brand names are combined?
- What are the short- and long-term actions planned by Unilever?

7.2 Advantages and disadvantages of local companies

Generally there are three main characteristics of the companies Unilever acquired in CEE:

- They are traditional producers of products within Unilever's portfolio (you buy brands, not assets);
- They hold strong positions in their national markets;
- They have potential to grow in both volume and range of products.

These three characteristics match Unilever's primary objectives: to take up leading positions in the local market and to establish operational bases in the countries as soon as possible.

Pollena Bydgoszcz, Unilever's first acquisition in CEE, was the leading laundry detergent producer in Poland. Although it held good market positions in Poland, Pollena would not have been able to maintain these positions when foreign multinationals would enter the market with high quality products. Pollena could have only survived if it had allocated many resources (R&D) into the development of new products.[25]

The second largest acquisition in Poland was of the state-owned company for edible fats and oils; Slaskie Zaklady Przemyslu Tluszczowego (SZPT) which at the time of the transaction was producing 45 000 tonnes/year of margarine and edible fats and oils representing about 8 percent market share.[26]

NMV, one of the largest Hungarian companies with six production locations, acquired by Unilever in 1992, was the local market leader in margarine as well as a major exporter. In addition, the company held a strong market position in detergents and soaps. The turnover of the company was US$ 290 million in 1991 with 3 000 employees (giving it a relatively high productivity for CEE). Since 1971, NMV had a know-how agreement with Unilever, including the right to use its Rama brand.[27]

The Hungarian company Bajai Hutoipari, in which Unilever acquired 96.3 percent in 1993, is a significant producer of frozen vegetables for the local market and for export. It is located in an agricultural part of Hungary and had traditionally good links with farmers.[28]

The Czech state-owned company Povltavske Tukove Zavody (PTZ), acquired by Unilever in 1992, had a strong role as a local producer of margarine, soap and personal products. After a year, the company was able to adopt the production of Rama with which Unilever holds a leading market position in the country. With regard to soaps PTZ had a considerable share

in the local market. Its export positions provided additional development potential.[29]

DERO, which Unilever acquired for 70 percent in 1995 (currently 100%), was Romania's leading detergents producer. The company held a leading position in the washing powder market and had considerable success with detergents in export markets.[30]

In 1998 Unilever acquired a controlling interest in MMZ (Moskovsky Margarinovy Zavod), a leading Moscow producer of margarine, cooking fats and mayonnaise. The business employed approximately 350 people. An initial investment of over US$ 20 million followed the acquisition and was aimed at improving production facilities to meet Unilever's standards and to further develop the business. Unilever also initiated a training programme for MMZ employees in management skills and business systems. It was expected that MMZ's knowledge and understanding of the Russian yellow fats market would contribute significantly to the development of Unilever's business in Russia.[31]

7.3 Local and international brands

Unilever relies to a large extent on strong brands. Strong brand names are sustainable in recession-hit markets while being an instrument of growth elsewhere.[32] This philosophy is applied to CEE taking into account some traditions in brand names and in consumer behaviour:

a) The markets in the region do not have strong traditions in brands and thus consumers were not used to become attached to a certain brand name. The low variety of local products, which did not provide much choice, built up a passive consumer attitude towards goods in general. Now, not only foreign but also local companies are facing the problem of building consumer loyalty towards brands.
b) Building up brand loyalty is difficult in countries where a good brand counts for less than a good price and where a constant stream of new products keeps consumers curious. While in developed markets mainly young people tend to change brands frequently, in Hungary for instance 40 percent of brand switchers were older than 35.[33]

After an explosion of the interest of CEE consumers' in Western products, a period of "nostalgia" for local brands could be observed. This was caused by several factors: there was a substantial price gap between foreign and local products; the quality of some Western products appeared to be lower than expected and thirdly, there was emotional attachment. "Calling it a renaissance of local brands puts a wrong touch on it", says Mr J. Berner, Unilever's former Director for CEE. He called shoppers' affinity to home-grown goods "an economic necessity".[34] The local competition

particularly influenced the food sector, where consumers spent most of their income.

As a rule Unilever combined its mature international brands with local brands of the CEE companies that it acquired. For instance, Lever Polska is now marketing detergents and cleaners and personal care products under international brand names. At the same time it is selling local brands such as Pollena 2000 washing powder that is the market-leader and earns high popularity through its advertisement based on a Polish legend.

The production range at Poland's SZPT, is progressively expanding to include international Unilever brands in margarine and edible fats, in which products have a constantly high quality. Similar is the case of the Czech company PTZ where Unilever manufactures its international brands after investing in production technology and methods. The local margarine brands of PTZ will be maintained and improved because they have market potential. To ensure constant quality is one of the main reasons to lend one's international brand name to a new producer. The quality is influenced not only by the production technologies and methods employed in the company, but very much by the supply in terms of constant quality and regularity. This was one of the reasons, for instance, why Unilever decided not to buy two margarine companies in Kazakhstan. "With laundry detergent, it's not crucial, but margarine, a perishable food product, has to be available every day", said J. Berner in 1995.[35]

One of the advantages gained by Unilever through building up consumer loyalty in CEE was the popularity of some of its international brands much before the changes in these countries took place. Brands such as Lux soap, Axe, Denim and Impulse deodorants and after-shaves, Rama margarine and Omo detergent were not new to East Europeans. The challenge was to replace the imports with home made Unilever products of the same quality maintaining at the same time the local brands wherever possible. For instance, in Hungary the sales of Panda, a local brand of ice cream produced by VNTV, melted away after Unilever began importing products from Western Europe.[36] Successful local brands can answer consumer's requirement for high quality, low prices and satisfy patriotic emotions.

7.4 Unilever's action plans

For every acquisition Unilever made in CEE there were three main components in its action plan: building up the product portfolio, improving or very often setting up the distribution and the supply chain, and training the local staff. All these components were backed up with a follow up investment.

Many CEE companies used to have a diversified, but not optimal product portfolio. To consolidate the product range within the core business that also coincides with Unilever's core business was one of the first steps taken in the companies' restructuring. Establishing a sensible combination of local and international brands was the next step that led to measures to improve or replace production technologies and methods and to define the optimal scale of production. If it is to be successful, the restructuring in CEE companies needs to be accompanied by training of local staff. The main policy of Unilever everywhere in the world is to build up a strong local management team. Therefore, programmes for recruitment and training are an important part of its action plans. Training programmes are also introduced at the levels of manufacturing, marketing and distribution of branded products.

In some parts of CEE, distribution is the decisive success factor. To get the product to the customer and to do it efficiently has been and still is one of the problems in the region due to the lack of structured national distribution channels. The same applies to the supply. In practice, most companies build their own supply chain in order to ensure quality and regularity.

Unilever has invested substantially in all three elements. For instance, within only two years after the establishment of Unilever Magyarorszag in August 1991, Unilever had invested more than US$ 100 million in Hungary on acquisitions, investment programmes, training of personnel and the development of distribution systems and marketing and sales organisations.[37]

A good summary of one of Unilever's action plans in CEE is given in the address given by Mr Floris Maljers, then President of Unilever, at the signing ceremony of the acquisition of Polena Company in Warsaw:

"However, more important than money are people. We will set up a major programme to train people in the latest technology in processing. In addition, we will have to consider the best way to distribute and sell our products. We intend to strengthen the existing marketing by appointing two expatriates and one Polish director in addition to the already functioning board. The introduction of more efficient production methods will reduce the number of labour places in the existing departments. On the other hand the increase of the production capacity of powders and the new liquid department will provide new opportunities for employment".[38]

7.5 Dealing with constraints in CEE

The first type of external constraints comes from the governmental policy concerning inflation, a commercially sound taxation system, accounting system, etc. Inflation accompanies the creation of the market in these countries, although the international financial institutions insist on keeping

inflation low. A typical reaction is that the governments increase taxation and introduce all kinds of new taxes. Costs like advertising are not always tax deductible. As a result, a distortion between profit and investment occurs.

Red tape caused problems as well (it still does). Procedures were not clear and often contradictory. Some things, which were usual in the West, did not exist in the East (for instance bankruptcy laws). This can be an advantage for those who enter the region first because they can "create" procedures or they can be "precedent cases". The first companies to be there build up the national learning experience.

The short-term thinking of many people in CEE is disturbing: they wish to have cash today. Therefore, partnerships with local companies are difficult and often tricky. The same applies to the expectations of employees whose understanding of working for a foreign company is very often identified with higher salaries.

In order to diminish the internal constraints Unilever applies a management control structure. Cash and assets management is one of the first tools introduced. Market research takes place in order to tune the product to suit the customer. Refurbishing of factories comes up when backlogs have been identified.

7.6 The movement of suppliers into CEE

Unilever did not have a specific approach in influencing its traditional suppliers to establish activities in CEE. Nevertheless, it encouraged them in informal talks to follow Unilever. Some packaging companies moved, so did advertising agencies, market research institutes, accounting companies, consultants and so forth. The pioneers in CEE lacked many of the necessary elements of a business infrastructure, including supply. This can be turned into an advantage as these companies have the opportunity to build this infrastructure themselves. Unilever has established relationships with local suppliers in CEE. Local suppliers are capable of setting up supply activities provided there is a little help from outside. In cases where strategic products for Unilever are produced, foreign suppliers are used.

8. MAJOR ACQUISITIONS OF UNILEVER IN CEE

Country	Year	Local company (description)	Transaction data (share, price, acquired business)	Local company's advantage	Unilever's actions (in the coming years)
Poland	1991	Pollena Bydgoszcz (new name Lever Polska); 430 people	80% (now 100%) US$ 20 mln detergents	Leading laundry detergents producer in Poland; popular local brands (Pollena 2000)	Total investment of US$24 mln; increase capacity add international brands; train employees
Poland	1992	Slaskie Zakladey Przemyslu Tluszczowego (SZPT "Olmex"); annual turnover US$ 30 mln; 800 people; 45 000 tonnes margarine; two production locations	70% (now 100%) US$ 25 mln margarine, edible oils and fats	Leading position in manufacturing and marketing of margarine and edible fats in the country; local brands	US$ 14 mln investments; new production lines for international brands; education and training of locals; establishment of marketing and sales organisation
Poland	1993	Roma International; private	Ice cream		US$ 17.5 investments; establishment of nation-wide sales and distribution network for ice cream in Poland; introducing international brands
Hungary	1992	NMV; 3 000 people; six production locations; turnover US$ 290 mln	80% (now 100%) margarine, soaps and detergents	Market leader in margarine in Hungary; one of the most important companies in the oilseed sector in Eastern Europe; strong market position in detergents and soaps	International brands for margarine will be added; NMV detergents product ranges will be upgraded as quickly as possible; to compete with businesses outside Hungary; training of locals
Hungary	1993	Bajai Hutoipary; 500 people	96,3% US$ 3.7 mln quick frozen vegetables	Significant producer for local market and for export; links with farmers	US$ 5 mln investments; improving facilities; expanding

					capacities; transfer of new technologies; improvement of the supply chain
The Czech Republic	1992	Povltavske Tukove Zavody (PTZ); turnover US$ 20 mln; 400 people	100% more than US$10 mln; edible oils and fats, toilet soap and skin cream	Significant share of the market; traditional exporter of soap to other Eastern countries	US$ 15 mln investments; new line for Rama; expanding production of soap; training
Russia	1994	Severnoye Siyaniye, St. Petersburg; 1 000 people	90% (now over 95%); fragrances, after shave and colour cosmetics	Leading producer in the region	US$ 10 mln investments; broaden company's portfolio; training
Romania	1995	DERO; 1000 people	70% (now 100%) about US$ 20 mln detergents	Leading detergents manufacturing; leading market position in fabric powder with popular local brands; successful export	Investments in modernisation; environmental standards; training
Russia	1998	MMZ; 350 people	Controlling interest	Leading Moscow producer of margarine, cooking fats and mayonnaise; understanding of Russian yellow fats market	Initial investment of US$ 20 million to up-grade the production facilities to the standards of Unilever; training of staff

NOTES

[1] Special Report FT 500, in Financial Times, 18 May, 2003
[2] Words of the founder William Lever quoted in: "Days of making hay are over", Financial Times, 26 July, 1993
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[4] Unilever's official data from annual reports
[5] "Unilever's Latin American Food Business Strategy", Teaching Note, written by Professor Fernando Robles of George Washington University; CIBER Case Collection, 2000, p.3
[6] "Unilever's Food Business Strategy in Latin America", Case written by Professor Fernando Robles of George Washington University; CIBER Case Collection, 2000, p. 2
[7] Unilever plans fast growth, Unilever Press Release, 22 February, 2000
[8] Ibid
[9] Unilever's official data from annual reports
[10] "Munching on change", The Economist, 6 January, 1996

[11] Unilever acquisitions and disposals in 1999, Unilever Press Release, 22 February, 2000
[12] Unilever Annual Report 1996
[13] "Unilever's Food Business Strategy in Latin America", Case written by Professor Fernando Robles of George Washington University; CIBER Case Collection, 2000, p. 3
[14] In Central and Eastern Europe Uniliver includes all former centrally planned economies
[15] The 1993 brand *Promise Ultra,* introduced in the USA, has the lowest fat content of any product in this category on the market. Following the acquisition of Bertolli in 1994, Unilever holds a strong position in all major olive oil markets in Southern Europe.
[16] "Munching on change", The Economist, 6 January, 1996
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[18] Unilever Annual Report 2002
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[29] "Unilever acquires Czech state-owned margarine and soap business", 25 September, 1992, Prague (Unilever-News)
[30] "Unilever acquires Romanian detergents producer", 4 may 1995, Budapest (Unilever-News)
[31] "Unilever acquires Russian margarine business:, 26 March 1998, Rotterdam (Unilever-News)
[32] Opinion of Mr Floris Maljers, former Unilever Chairman, in: "Unilever relies on strong brands", The Netherlander, August 28, 1993
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Chapter 9

Numico

1. INTRODUCTION

Numico, known not long ago as Nutricia, is a more than 100 years old company that has developed from a small Dutch dairy factory to one of the most powerful multinationals in the field of baby food, clinical nutrition and nutritional supplements.

In 1896 Martinus van der Hagen, founder of the Steam Dairy Factory in Zegwaard (Zoetermeer, the Netherlands), obtained the exclusive rights to produce an infant formula from cow's milk using the Backhaus method. Not long after that, the Nutricia concern was established.[1] In close collaboration with the medical profession, Nutricia even before World War I produced its first special diet products such as low sugar milk for diabetic patients, and iodine containing milk for goitre patients. After World War II, Nutricia developed itself into a producer of knowledge-intensive nutritional products. In 1946, the company's laboratory was expanded to accommodate a research department with facilities for a pilot plant. Also in 1946, the first Olvarit vegetable-containing baby meals appeared on the market, and over the course of years the assortment of these foods, as well as porridges was greatly expanded. The first dieticians were hired in 1950 to provide medical information to, among others, doctors and nurses. The many technological advances of the 1960s resulted in new developments in hospital nutritional products. This led to the introduction of, among others, Nutri 2000 (1970), a complete nutrition for the chronically ill with serious feeding problems, and of the Nutrison Pack (1995).

The name Nutricia was changed into Numico in 1997 when the company was awarded the designation “Royal”. Since 1966 the company is listed on the Amsterdam Stock Exchange.

Nutricia has been exposed to the international market as of 1905 primarily exporting milk powder products. The first factory abroad (in Belgium) was purchased in 1924 and in 1963 a third production unit in Belgium became operational. The main formula for growth of Numico has been growth through acquisitions. Major acquisitions were carried out in 1981 (Cow & Gate), in the 1990s in Central and Eastern Europe, in 1995 (the German Milupa) and in 1999 (General Nutrition Companies, GNC). As a result Numico has shown a substantial growth in turnover in the 1990s (see Figure 9-1). Numico has 42 factories worldwide at present.[2] The company operates in more than 100 countries and employs more than 28 500 people.[3]

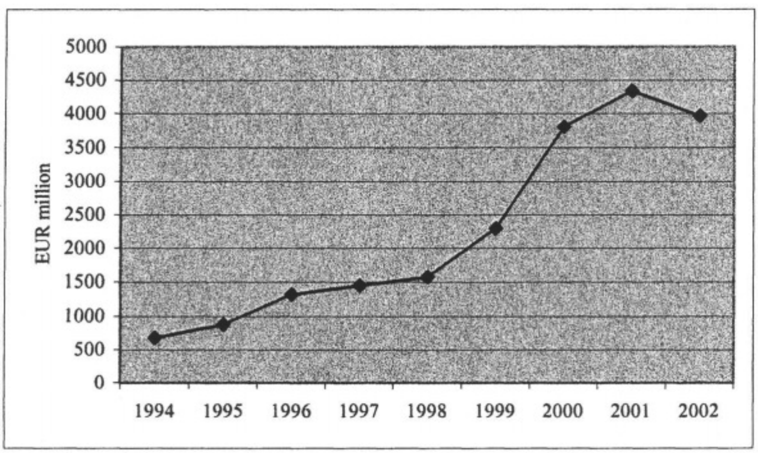


Figure 9-1. **Net turnover of Numico**

Starting out with a high quality infant milk formula in 1901, Numico has become a specialised high quality food company over the years. The company distinguishes three product groups:[4]

- *Infant nutrition:* infant milk formula, meals, drinks, juices, cereals for children;
- *Clinical nutrition and dietary food:* enteral clinical nutrition, dietary products and medical nutrition;
- *Nutritional supplements:* vitamins, minerals, and herbs.

The first two groups have been representing about 70 percent of the total sales of the company for many years till Numico’s acquisition of GNC in 1999.

Table 9-1. Total sales by product group, 2002

Product groups	Net sales*	% of net sales
Baby Food:	**1 060**	**27**
Infant Formula	705.96	18
Cereals	160.06	4
Meals	146.28	4
Other	47.70	1
Clinical Nutrition:	**514**	**13**
ENC (Enteral Clinical Nutrition)	282.70	7
Metabolic and Dietetic products	179.90	5
ESP (Enteral Supply Products)	51.40	1
GNC	**1 432**	**36**
Discontinued **	**960**	**24**

Source: Numico Annual Report 2002
* In € millions
** The 'discontinued' activities group includes Rexall Sundown, Unicity, vitamin activities in Europe and dairy activities in India and Brazil – activities divested by Numico in November 2002

Numico is the European market leader in infant nutrition and medical nutrition. It is the market leader in the US in the field of nutritional supplements. Numico is also market leader in infant nutrition in some countries in the Far East.

With the infant milk formula products (IMF) Numico shares the market with companies like Nestlé and Wyeth amongst others, maintaining a high market share (see Figure 9-2.)

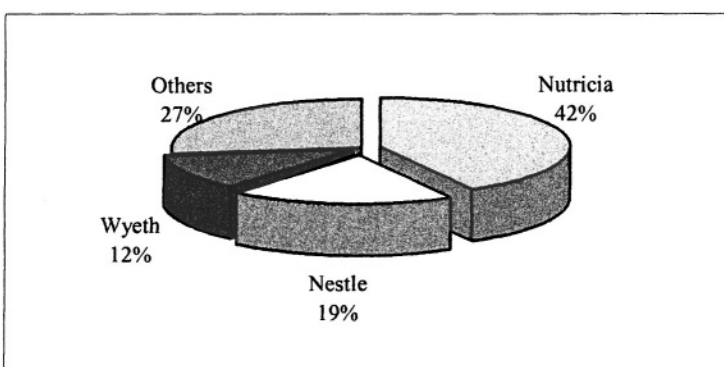


Figure 9-2. **European market shares IMF (in %)**

With regards to the enteral clinical nutrition products (ECN) the market share of Numico outperformed competitors such as Clintec, Fresenius, Abbott and Sandoz (see Figure 9-3).

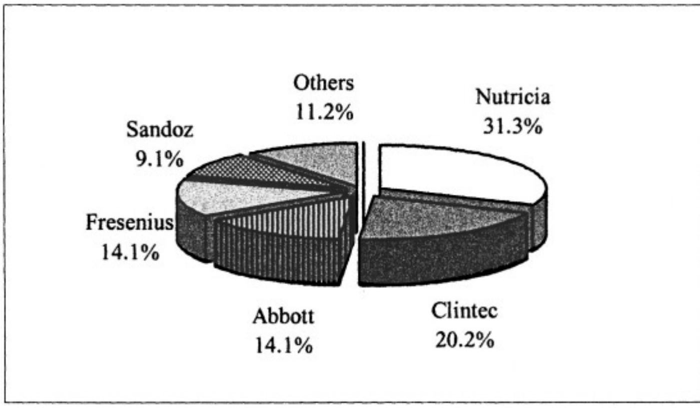


***Figure 9-3*. European market shares ECN (in %)**

As defined in the company's 1994 Annual Report, "Numico's policy is aimed at two main objectives, internationalisation and specialisation, with emphasis on the international expansion of the primary core activities". The specialisation is very much based on the company's concept of high quality nutritional products based on the results of broad based research and close partnerships with the medical world. This expertise and scientific knowledge provide a good opportunity for quick and smooth shifts from commodity type products to speciality products. The latter forms to a large extent the new competitive edge of the company in saturated markets such as Western Europe in general and the Netherlands in particular.

Numico is active in five groups of markets formed on a regional principle:

- The USA;
- Europe: Northern Europe, Central Europe, Eastern Europe and Southern Europe;
- Asia Pacific;
- South America;
- Africa.

In mid-1990s sales in Central Europe, where the activities of Numico originated, represented the largest share of the total sales of the company (37.4%), followed by Southern Europe (24.7%), Northern Europe (16.4%) and Eastern Europe (11.2%).[5] Nowadays Numico's product portfolio shows a wider regional spread. More than 50 percent of the sales go to the USA and about 9 percent to the countries of Asia Pacific region and South America.

Eastern Europe attracts about 5 percent of the net sales of the company (see Table 9-2).

Table 9-2. Net Sales by regional groups, 2002

Regional groups	Net Sales*	% of net sales
Northern Europe	633	16
Central Europe	251	6
Southern Europe	341	9
Eastern Europe	**208**	**5**
North America	2 182	55
Asia, Africa, Australia/Pacific and Central and South America	351	9

Source: Numico Annual Report 2002
* In € millions

The management structure of Numico has been adapted to the present activities of the company. In the mid-1990s the company was structured in six regional groups, each of them headed by a Group Manager. Together with the Manager of Corporate Affairs the Group Managers were forming the second management layer of Numico, the so-called Group Management.

At the end of the 1990s a decision was made to align closer the organisational structure with the product portfolio. There are three divisions at present: Baby Food, Clinical Nutrition and GNC (nutritional supplements). The three divisions are oriented to all regions of the company's geographic portfolio. Next to these three divisions, Research & Development and Operations are also represented in the Executive Board. The one-layer structure aims at increasing the management effectiveness, shortening the lines of communication and making responsibilities transparent.[6]

Almost all levels of management are concerned with decisions regarding the company's expansion abroad. The Executive Board discusses general policy issues of the company. On a regular basis the Numico's Supervisory Board is informed about strategic issues. With the Central Workers Council, a regular exchange of information takes place. The Central Workers Council has paid very close attention to developments in the growing markets in Central and Eastern Europe and the Far East, which in the long run could have consequences for the rellocation of production.[7]

The changes of the organisational structure of Numico in the last decade of the 20th century have been focused on choosing the right level of decentralisation. In mid-1990s the structure was more decentralised than at present, reflecting the growth phase of the company. Product development and innovation have been decentralised to the manufacturing units. Research and development is now within one division that aims at boosting the

innovation base of the whole company. Numico has located its main R&D activities in the so-called food valley in Wageningen, the Netherlands. R&D facilities of Numico have been built or acquired in Germany, the UK, the USA, Australia and China. At the same time, it utilises R&D available internationally, maintaining close links with more than 50 university research centres worldwide.[8]

2. NUMICO'S INTERNATIONALISATION STRATEGY

Numico's corporate strategy is based on four key factors: *specialisation, internationalisation, profitable growth and the highest of quality standards.* The four factors are interrelated and can very often reinforce each other. They form the competitive edge of the company: to develop, manufacture and market a range of highly specialised baby food and dietary products with the highest possible quality, thus enlarging the company's markets and increasing its profitability.

Internationalisation, as part of Numico's general strategy has been present since 1924. The real expansion of the quality baby food range into foreign markets began in 1981 when the company took over Britain's Cow & Gate. At the start of the 1990s, the company accelerated its internationalisation process by opening new sales offices in Europe and beyond. Targeted acquisitions and the regular introduction of new products strengthened Numico's position in the fields of infant milk formula and baby and toddler meals, as well as enteral clinical nutrition and dietary foods. As a result of its cautiously designed internationalisation process, Numico nowadays has branches in all the regions mentioned in Table 2.

With expansion abroad, Numico pursues two major strategic objectives: *to enlarge its market and to strengthen its market positions, and to search for cost advantages in production and marketing.* As it is virtually a monopolist in the baby foods market in the Netherlands, Numico does not have much space for growth in this market. This is caused by the fact that no more than 200 000 children are born each year in this county and the number is not rising.[9] In other West European countries a similar kind of market equilibrium can be observed. A direct expansion or new entry into these markets is only possible through a "re-distribution" of market shares. For this reason Numico entered markets like France and Germany through the acquisition of Milupa and thus into direct competition with the dominant Danone in France or Nestlé in Germany.

The management of costs will increasingly require greater attention from companies within the European Union, particularly when the costs should be

balanced with the export. Companies will search for the cheapest location, especially for products, which are logistically an expensive item such as cereals for instance. "Local for locals"[10] will in many cases be the optimal solution.

Therefore, two other ways of market penetration or market growth have been chosen: *introducing completely new products and acquiring local companies.*

– *Introducing completely new products*

As recognised by its competitors, two of Numico's strengths are the speciality foods and diary products sectors.[11] In addition, the company progressively introduces milk formulas for older babies while it focuses increasingly on users of special dietary and clinical foods. Thus, Numico tries to gain advantages from structural changes in the Western markets, including the Netherlands, caused by the latest demographic developments. The consistent strategic emphasis of the company on R&D leads to innovative formulas for its products (such as the new fatty acid to be used in food for premature babies) that as a rule are first introduced on markets where Numico has leading positions. In 2001 for instance, sales of infant nutrition in Europe were driven by innovative products[12] and the strategy to extend the usage of infant formula with a new concept (e.g. 1-2-3 Concept[13]).

– *Acquiring local companies (usually today's competitors or future competitors)*

In markets that are dominated by only a few brands and that are very much saturated, like the baby foods market, the take-over of competitors is one of the ways to enlarge one's market share. In this situation, the take-over can often be hostile. Such takeovers were foreseen for Numico after America's Gerber was taken over by Switzerland's Sandoz and the spotlight increasingly focused on Numico as the next take-over candidate. Therefore, Numico's move in 1995 to acquire Germany's Milupa can be considered as a strategic move at an appropriate moment. The result of this take-over was that Numico expected to control more than 40 percent of the European infant milk market in comparison to roughly 25 percent before the acquisition. "Numico's turnover increases from € 0.7 to € 1.2 billion, which made it the largest company in the baby food sector in Europe, and put it in front of competitors like Nestlé and Danone (Bledina)".[14] In addition, the acquisition of Milupa did not only strengthen its position in the German market but also in those of France, Italy and Spain, markets where Numico was weak before the take-over.

Similar was the objective of the acquisition of General Nutrition Companies (GNC) in 1999. This has introduced a new product group into Numico's portfolio as well as a substantial presence on the USA market. The

take over of US Enrich International Ltd. in 2000, provides an access with nutritional supplements and products for personal care to 14 countries where Enrich International is active.[15]

"Smaller in scale, but strategically of equal importance, were the acquisitions of Qihe Dairy Corporation Ltd. in China, Mococa S.A. in Brazil and the dairy company of Hindustani Lever Ltd. in India. These acquisitions perfectly fit the strategy of Numico to expand and strengthen its position in infant milk formula in the Far East and South America. Furthermore, early 2000 Numico acquired Wuxi Chia-Tai Pharmaceutical Company Ltd. in China".[16] Numico has a market share of more than 55 percent in enteral clinical nutrition in China that is expected to grow with the expansion of the local production.[17]

It is vital to emphasise the importance of the combination of the four key strategic factors of Numico's policy, particularly specialisation and internationalisation. One cannot rely on internationalisation only, especially in the difficult market situation in which Numico operates in Western Europe. As a market player Numico is a small sized competitor, with a turnover of about 10 percent of that of Unilever for instance. However it has chosen the combination of internationalisation and specialisation, and therefore it is an expanding market leader in a specialised market segment for baby foods in Western Europe. The acquisition of Smith's Reform B.V. ("Zonnatura" and "Pharmafood") in 1994 for example, provided opportunities for further growth in the dietary products sector together with market expansion prospects.

The argument for Numico's internationalisation policy towards emerging markets such as former socialist countries (further to be called Central and East European countries, CEE and CIS), and Far East and South American countries is somewhat different. The picture of these markets is different in comparison to the markets of the industrialised countries: *there is growth potential in both product range and market share*. "The strategy of the company remains focused on profitable international growth in specialised nutrition. The growth of infant milk formula should mainly come from South America and the Far East, where the consumption of infant milk formula is still relatively low".[18] Whoever is first in these markets faces a low level of competition in the beginning. In the case of Central and Eastern Europe this situation prevailed for no more than a couple of years. For large multinational companies the competition very quickly becomes even greater than that of the Western markets: all multinationals are present there and strive for as high as possible market share in a short period of time. Investments are comparatively high in this period, but the margins are low.

The economic and political changes in CEE and CIS in the 1990s have provided new opportunities for Numico's internationalisation process.

Special attention has been paid to Hungary, the Czech Republic, Poland, and later on to Russia. The primary focus was to obtain and maintain substantial market shares in these markets. As a result, the turnover of Numico from European countries outside of the European Union almost doubled in 1995 compared to 1994 and represents 11.9 percent of the company's total turnover at present.[19] Part of the reason for the sales increase of 1995 was due to Numico's East European markets: cereal sales rose by € 7.7 million partly as a result of strong growth in Eastern Europe; 7.8 percent of the 12.3 percent rise in the meals, drinks and juices group was generated by new acquisitions in the Czech Republic and the introduction of some of these products in the Russian market; the sales increase in the "other products" group was partly due to new sales of both cheese and butter and to the sales of full and skimmed powdered milk, both at Wegrow in Poland.[20] Numico's entry into the markets of Eastern Europe not only influenced the sales positively, but it further consolidated the company in its primary core activities, in which the percentage volume rose from 58.6 percent to 71 percent over the ten year period 1985-1995. In the years after 1995 Numico managed to maintain a growth of the sales in CEE of about 10 percent per year on average.

Other emerging markets to which Numico pays equal attention are the Far East and South American countries especially Argentina and Brazil. The dilemma for Numico was not "CEE or Far East or South America?" but "CEE and Far East and South America!" if one should remain or become a market leader. Two considerations are important here: how far the company develops and how it should divide resources in order to be able to enter all emerging markets. "We noticed fast the actions of Western companies in CEE because the opportunities there came at short notice. The Far East is also very attractive - that's where the babies are".[21] Numico has a production plant in Indonesia and it operates in Hong Kong and Singapore. Production facilities in Australia and New Zealand provide additional opportunities to serve Far East countries. Due to an acquisition in New Zealand for instance, Numico gained access to the market for infant milk formula in the country itself, in Australia and in a number of other countries in the Far East.

One of the results from growth through continued acquisition is the "widely dispersed manufacturing platform in Europe with significant overcapacity".[22] The optimisation that Numico is striving for at present should reduce the number of plants from 16 to 9 by the end of 2005 on the basis of the most favourable cost structure and possibilities for increase of production. Such optimisation is expected to "significantly simplify the network complexity as well as the use of technology per plant within the European manufacturing platform".[23] The seven plants that will be taken out of the network are located in the EU, three of which are in Germany, one in

Spain, one in the UK and one in Austria. Three of the plants from the consolidated European manufacturing platform for baby food of Numico are located in CEE. These are two Polish producers (Krotoszyn and Opole) and the Czech plant for jars Deva.[24]

To summarise, two major trends characterise the internationalisation policy of Numico:

- Numico is a market leader and would like to strengthen its positions as such. Its position in the slowly growing Western markets is maintained by introducing new product groups such as nutrition for patients (enteral clinical nutrition; diet food, new infant milk formulas, etc.). There is little to be added to the baby food group in which Numico has been active and leading in the Netherlands for the last 40 years. In this way the company tries to diversify at home, shifting from the commodities market to more individual products, where substantial know-how and research is needed.
- Parallel to product diversification, Numico expands abroad by transferring well-established know-how to markets where there is demand for commodity type products. Together with the objective to remain a market leader, this serves as a primary reason for investments in CEE. As a result, Numico has been a growing market leader in CEE in the 1990s, being one of the first in the business to enter that market. Some of Numico's product groups that have become commodities in saturated Western markets faced substantial demand in the growth markets of CEE. Thus, the life cycle of these products has been extended and an economy-of-scale effect has been achieved.
- Numico moved to CEE first with its strongest product group, baby food. At the same time, Numico was monitoring the developments in CEE markets that would allow expanding with the rest of its portfolio.[25] The market was ready in about five years to absorb the whole product portfolio of Numico (with the exception of supplements that were added to Numico's portfolio later in the 1990s).
- Numico built up a network of manufacturers that produce locally for local customers. Lately the network became strong enough to form the core of the consolidated manufacturing base of the company in baby food within Europe.

3. NUMICO IN CENTRAL AND EASTERN EUROPE

Numico did not apply a special methodology in investigating the opportunities and the risks involved in CEE: the changes were too fast there and the actions required also had to be fast. The main approach it used was

based on direct observations of Numico's experts and decision makers in the region, starting with Czechoslovakia (at that time), Hungary and Poland. The fact that baby food production and distribution was highly centralised in these countries defined Numico's approach to begin talks with governmental authorities. At the same time, companies in the region were looking for a partnership that would give them a new solution for the market and financial problems they faced and in addition would offer other options rather than a full take-over.

Although traditional trade could have been a means to enter CEE, it was only used for a short time because of high import duties for products in the food sector. The approach was to investigate possibilities to buy state monopolies that could offer Numico their local markets. There was one such company in the Czech Republic, one in Hungary and three in Poland. In addition, these monopolies owned local brand names, quite popular amongst customers. In baby food particularly, it is very important that the customer knows and trusts the brand. Many of the CEE countries were very good regarding the production of these products (baby food and pharmaceuticals), which was strictly controlled by the state while much attention was paid to the quality. Therefore, the quality offered by some CEE companies was judged to be good by Numico, particularly the quality of the Hungarian products (primarily milk products.)

In its quick move to CEE, the risk for Numico was limited compared to the size and the financial status of the company. It could only loose the money invested and that was calculated as a relatively small risk.

Partnership is Numico's form of investment in CEE. Numico has entered into several joint ventures (see Table 9-3):

- In the Czech Republic with Deva, Rekord and Mlecna-Vyzina;
- In Hungary with Egis (51%) and Haidutej (a 22.5% interest was acquired in May 1995 which rose to 79.6% later); Hajdútej acquired 51 percent of the dairy company Szabolcstej in 1999. Szabolcstej is a dairy company located in the Northeast of Hungary, in the region north of Hajdútej's region. The company has two production plants in Mateszalka and Nyiregyhaza. "The acquisition is a logic consequence of the concentration tendency in Hungary and fits excellently in the Nutricia Dairy & Drinks operation in this Central-European country";[26]
- In Poland Numico owns 50 percent of Ovita and currently Ovita owns 100 percent of the dairy factory Wegrow;
- Late 1995 Numico acquired a 50 percent stake in the Russian company OAO Istra, which produces baby foods; it increased its share to almost 100 percent at present.

Although called a joint venture, the partnership construction in all cases is more a take-over than a joint venture. The joint venture takes over the core business of the CEE partner. No new entities have been established. Therefore, it is a method of take-over under a different legal construction. This is because some local legal regulations offer better and faster arrangements for joint venture construction than for other forms of investment. It also appeared to be the preferred form of some of the local partners of Numico.

Table 9-3. Numico's subsidiaries in Eastern Europe

Subsidiaries in Eastern Europe	Location	Share in %
Numil Hungary Kft.	Hungary	100
Nutricia Poland B.V.	Zoetermeer, the Netherlands	50
Ovita Nutricia Sp. z.o.o.	Opole, Poland	49.9
Ovita Nutricia Wegrów Sp. z.o.o	Wegrów, Poland	50
Sodad Nutricia a.s.	Prague, Czech Republic	100
Nutricia a.s.	Prague, Czech Republic	100
Deva a.s.	Nové Mesto, Czech Republic	
Nutricia Slovakia s.r.o	Bratislava, Slovak Republic	100
OAO Istra Nutricia	Istra, Russia	94
Nutritek Istra Nutricia o.o.o.	Moscow, Russia	98.2
Nutricia Russia LLC	Moscow, Russia	100

Source: Annual Report 2002

In all cases the CEE partners of Numico were available for privatisation or were already privatised at the time of the transaction. In some cases, as in Poland and Russia, the local companies were privatised and they belonged partly (25% in Poland) or mostly (50 % in Russia) to the personnel and the management. The negotiations opened up possibilities for a buy-out of shares from the workers that seemed to be a popular and successful approach for many Western companies investing in CEE privatised enterprises. The construction of a joint venture, where a Western company shares an entity in CEE with the personnel of the local company, its management and sometimes with local banks, is not the most favoured one. Almost without exception, Western partners pursue a majority approach to these countries. In cases, where this is not possible, clauses in the initial contracts that strengthen the control of the Western company over the joint venture have to be included. In all cases Numico legally required management control over its CEE joint ventures. Moreover, in the case of Hajdutej (Hungary), where

the initial share of Numico was 22.5 percent, the contract stated that other parties (other than Numico) could not have a majority share in the company.

A partnership is not only subject to the satisfactory distribution of shares, but it very much concerns the equality of the partners in terms of mutual respect. This also seems to be the philosophy of Numico that realises in practice two things: "We want to be in charge!"[27] and "I would like to work with our partners on an equal basis, as partners."[28] In all the cases in CEE, Numico has management control which is based on the argument that "one should be in charge" in order to pursue efficient decision-making. The partnership element of the approach is based on the complementary ability of the partners: one brings local markets and successful local brands for instance, the other - internationally recognised brands and modern know-how.

Numico was aware of the fact that it would face difficulties in pursuing some of the Western methods of restructuring, efficiency improvement and control in its CEE companies in the future. Numico also expects that the shareholders behaviour, which is a new concept in CEE, will soon become a practice as it is in the West.

CEE partners expect "fresh money", modern technologies and equipment, and management know-how from Numico. Numico agrees with this but it sees its contribution prioritised over time. First comes management know-how and, of course, payment for the shares. Next will come modern technologies and equipment where it is most necessary in the manufacturing process. Large investments come last.

4. INVESTING FIRST MEANS INVESTING IN COMPETITIVENESS

All of Numico's partners in CEE have been and still are some of the biggest. Often they are the only producer in their country of products of Numico's mix. In addition, there was virtually no competition in CEE at the beginning of the changes, which benefited Numico; the entrance of Numico into Poland was without any competition. The combination of two approaches, to be first on the market and to find the most direct way to conquer the market appears to be characteristic for Numico.

EGIS was the largest pharmaceutical company in Hungary. It was the only company that produced infant milk, popular with the local brands "Mildibe" and "Robebi", which now bear the name of Numico as producer. Numico, through EGIS, appeared to be the monopolist in baby milk in 1993. Three years later other Western companies entered the Hungarian market.

Numico and Milupa count for more than 30 percent on the Hungarian market.

Hajdutej, the other Hungarian partner of Numico and one of the biggest dairy companies in the country, had about 70 percent of the market in the Eastern province of the country and 10 percent of the national market. Its popular brand "Milly" was to be seen in many local supermarkets with prices that are competitive in comparison with imported products.

ISTRA was the only factory in Russia for baby food. This was the reason why the Russian Anti-monopoly Committee did not permit more than 50 percent of the shares to be sold to a foreign investor. The market has even more potential than that in Poland and Hungary.[29]

Numico wad not alone in coming to CEE. All global players in the field are present and they benefited from Numico's pioneering work. Numico is not afraid of competition because of what it has acquired: *local production infrastructure, local brand names and low costs.* Numico's market share in the three Central European countries comes to 90 percent in some products.

Numico retained the original names of the CEE companies it formed joint ventures with for clear reasons. It is very important in a market for baby food products that the mothers and the doctors (who in some cases have to prescribe the food) feel that Ovita Numico (Poland) or Egis Numico (Hungary), for instance, are local companies. Consumers are used to their brand names and have trusted them for a long time. In addition, the attitude of the mothers in the region differs from that of Western mothers. CEE mothers have the habit of doing more things themselves unless a doctor prescribes something. They like to take more time preparing food for the baby for example, whereas Western mothers often prefer quick food that requires less time. Numico paid attention to this difference and realised that local partners know more about the local habits than the newcomers do.

5. INVESTING IN CORE BUSINESS AND QUALITY

In almost all cases Numico took over companies in its primary core business. To be an affordable market leader is a very attractive position that Numico could achieve through local brands first. The introduction of a necessary quality system by Numico would solve some of the problems with local products. "If we say that the quality of the local products is not up to Western standards it is mainly related to such things as packing and solubility."[30] If one offers baby milk, which does not dissolve well, on the Western market, mothers will immediately switch to the competitor. This danger was not present in the beginning in CEE where the local customers came with these kinds of requirements only after some time. This gave the

opportunity to Numico's local companies to prepare for the required quality. One should not invest in quality improvements if the market does not require them.

6. INVESTING IN SUPPLIERS

The quality depends of course to a large extent on the suppliers. Suppliers of Numico's CEE companies are mainly local companies. If Numico cannot buy there or if the required quality level cannot be reached, the supplies will be imported. This is relatively expensive. Therefore, the quality of local suppliers is very important and Numico is interested in training local farmers, for instance. The company is even ready to invest in the quality of its suppliers. In CEE countries where milk factories used to be and still are working as co-operatives (e.g. Poland), this problem is not substantial. Where the farmers are not united, this is a problem.

Although the larger part of its suppliers is local, some of Numico's traditional Western suppliers followed its move to CEE. For instance, packaging companies have followed Numico. It appeared that the packaging materials could be produced cheaper in the Netherlands than in CEE in the beginning of the 1990s. Some producers of equipment for Numico's production lines have also moved to CEE.

7. INVESTING IN PEOPLE

The market is the primary reason for investments in CEE but the cost advantage provides an additional attraction to the region. In Mr van Hedel's opinion, CEE will sustain this advantage for the coming ten years and more. The governments there will try (if they are clever) to keep the salary low (under inflationary conditions), which first of all keeps the level of unemployment low and the cost advantage high. The factory in Hungary (Hajdutej), which was taken over in 1995, had about 1300 employees and a turnover of € 57 million.[31] Numico had at that time about 4400 employees and a turnover of € 0.7 billion.[32] This kind of factory there would need about 300 employees in the Netherlands. The productivity of the Hungarian factory was very low (about 4 times lower than in the Netherlands) but it was much cheaper to maintain the number of employees than to have social tension because of the introduction of new technologies. In addition, the latter would involve investments that cost much more than the labour costs at that time. The salary costs too, were about ten times less than those in the Netherlands. There was a suggestion to introduce an automated packing process at the end

of the production line. About 100 people out of 500 were involved in this process. However, it appeared to be much more beneficial to keep the labour than to invest in the automated process. In addition, if one started to reduce labour costs, one should first cut the very high overheads caused by too much administrative staff. Not only is the number of administrative staff 3 to 4 times more than necessary, but its attitude is very often counter productive. It still exercises the power that was assigned to the administrative staff in the centrally planned economy. This was the body in the company that was closest to the state authority. Still there are many administrative procedures that remain unchanged, which makes the restructuring process of the administrative departments in the companies quite difficult.

In almost all Numico's deals in CEE, it was not legally required to maintain the number of the employees after the take-over (with the exception of the Russian case). This meant that a reduction of overheads would not pose much of a problem. It is however Numico's policy not to reduce the workforce substantially. This is because, as explained above, the number of workers does not have a large effect on the profitability of the company while the "social cost" can be high.

One of the main problems in CEE is often the availability of appropriate personnel to take management positions and the mobility of good managers. Nevertheless, some of the subsidiaries have good managers. The observations of Numico's managers show that there is a lack of good people. Those who can change jobs fast are young people, under 40. Numico has an approach to train the local people, in the Netherlands and on the spot. Usually, Dutch specialists are sent (management staff but also technical staff) in order to train employees on-the-job. The language is a barrier. There are even cases where Dutch people begin to learn the local language within two to three months. In the provinces it is difficult to find people with foreign languages. In the cities, however, it is better. Even when there is a good command of the English language, local people do not understand lectures or training because the terms are new to them. Translation is needed in any case and training materials should always be provided in the local language.

With regard to staffing the new ventures in CEE, Numico aimed at building up a local team that would take over all functions in the near future. However, this appeared to be a bit optimistic. Dutch expatriates were sent there for only two years in the beginning with the expectation that the local staff will take over their functions. They were replaced with new expatriates afterwards because of the difficult job in these countries (resistance to change, slow understanding, complicated business, legal, accounting, administration, etc. procedures, not forgetting the different culture). The locals should be in charge right from the beginning. But they need a

counterpart - an expatriate. Local managers are important because they know the workers, the clients and the government. The local management should be kept intact. One of the local accountants mentioned that the government is more important to him than anyone from Numico, which of course reflects the influence of the state authorities on companies in CEE.

Numico usually sends expatriates for functions like marketing and sales, logistics, finance, general management (in a tandem with a local manager), technology and quality control.

8. INVESTING IN PATIENCE AND HOPE

The first Western entrants into CEE had to face many practical problems of a very different nature than those in the West. Often it is hard to understand the problems or one does not understand the logic behind them. Numico shares this experience especially in:

– The legal and administrative procedures are very complicated. There is a lot of paperwork; contracts are complicated. One needs a very good legal advisor.
– The bookkeeping is different and difficult to understand. One should maintain both a Western and an Eastern style of bookkeeping, and in order to succeed, one needs an experienced local accountant who can communicate well with the relevant bodies.
– International auditing companies are preferred but at the same time local state authorities often dislike them.
– International banks are present in the region in order to serve international clients first of all. Lately, local banks offer their services with Western quality and often lower prices.
– One should be aware of the changes in the distribution channels and the wholesalers' behaviour. Wholesalers used to pay in cash, but now they prefer concessions. One should be careful not to let wholesalers influence your sales and therefore to manage you as a producer.
– Environmental audit is something one should also undergo in CEE. Since the region has a bad image and no experience in this field, international companies should be used.

Negotiations with potential partners also require substantial attention. The experience of Numico shows that low positioned experts should never carry out the negotiations. This is a mistake many Western companies make. Numico usually send Board members to CEE. One should show respect for the local partners. In one of the deals in Hungary, the Director of the Hungarian company was not involved in the negotiations. Everything was carried out by the Privatisation Agency. The managers of Numico, however,

still found a way to register their respects to the manager of the Hungarian partner. In general, Numico carries out all negotiations and preparations for bidding and takeovers itself without the involving intermediaries. The bid for Hajdutej in Hungary took only six weeks, starting with completely open bidding, with 400 applicants at the beginning and three companies short-listed at the end. It is interesting to note that the difference in the proposed prices of the three companies was within five percent. Everything was open - no requirements, no price mentioned, no obligatory investment or labour plans and so on. Numico participated with an investment programme and marketing plan (all necessary components of a complete business plan).

Most patience should be directed to people in CEE who have two contradicting qualities: they are very intelligent and well educated, but they do not take initiative or responsibility. Younger people, 25 to 35 years old, display a new mentality, but they do not have the experience and hardly take on responsibilities. One should invest in people with experience by training them, but even then it may be not successful. Numico was convinced that locals would be fully in charge in some ten years after the changes. That is mostly the case in Central European countries at present where Numico has a stable presence – the Czech Republic, Hungary and Poland.

NOTES

[1] Numico own profile 2002, www.numico.com
[2] Ibid
[3] Numico announces the sale of part of the European supplements activities, Press release, Zoetermeer, 14 January, 2003
[4] Numico Annual Report 2002
[5] Annual Report 1996
[6] Annual Report 2002
[7] Annual Report 1994
[8] Annual Report 2002
[9] Numico makes good strategic move with Milupa, The Netherlander, 2-8 September, 1995
[10] Locally produced products for the local market
[11] Numico acquires Milupa, The Netherlander, 2 September, 1995
[12] Like Omneo/Conformil; see Result 2001, Press release 7 March, 2002
[13] This concept aims to extend the use of follow-on formula, based on the recommendation of physicians that cow's milk is not suitable for children under the age of one.
[14] The same as 7
[15] Annual Report 1999
[16] Annual Report 1999, p. 16
[17] Numico again expands business in China, Press release, Zoetermeer, 7 February, 2000
[18] Results 1998, Press release, Zoetermeer, 7 January, 1999
[19] Magie Westerse merken neemt af on Oost-Europa, NRC Handelsblad, May 5, 1995
[20] Numico Annual Report 1995, p. 18
[21] Mr T.J.M van Hedel, former Group Manager 'Numico Central Europe', in an interview with the author.

[22] Numico optimises its European Baby Food manufacturing platform to drive growth, Press release, Zoetermeer, 7 July, 2003

[23] Ibid

[24] Ibid

[25] For instance, enteral clinical nutrition (food for sick people) that was mainly exported to these countries

[26] Nutricia Dairy & Drinks will acquire Hungarian dairy company, Press release, Zoetermeer, 14 January, 1999

[27] Quoted statement of Mr van Hedel in: Nieuwe deal Numico aanloop naar meerderheidsbelang, Het Financieel Dagblad, 20 mei 1995.

[28] Quoted statement of Mr Zagoroejko, ISTRA Manager in: Numico verwerft Russische fabriek, Het Financieel Dagblad, 24 november 1995.

[29] Adapted from article: Numico verwerft Russische fabriek, Het Financieel Dagblad, 24 november 1995.

[30] Mr T.J.M. van Hedel in an interview taken by the author.

[31] Nieuwe deal Numico aanloop naar meerderheidsbelang, Het Financieel Dagblad, 20 mei 1995.

[32] Numico Annual Report 1994

Chapter 10

Sara Lee / Douwe Egberts

1. INTRODUCTION

Sara Lee Corporation, Chicago, USA, manufactures and markets high quality, non-durable, marketing-sensitive consumer products. It holds major market share positions in key consumer markets worldwide and owns more than 100 major brand names around the globe. Sara Lee Corporation focuses on products with growth potential in three categories: food products, consumer personal products and household and personal care products.

Sara Lee Corporation holds a 100 percent equity interest in Sara Lee/Douwe Egberts (Sara Lee/DE), 41 percent in the form of voting shares and 59 percent in the form of share certificates issued by an independent foundation (see Figure 10-1). Sara Lee/DE, with its headquarters in Utrecht, the Netherlands, manages the Coffee and Grocery, Household and Personal Care product divisions and the direct selling activities.

The history of Sara Lee/DE dates back to 1753 when Egbert Douwes and his wife Akke Thijsses opened a grocery shop “De Witte Os” in a small village of the Dutch province Friesland. Thirty years later, the son Douwe Egberts joined his parents and the shop grew into a coffee-roasting house and a tea and tobacco-trading company. Friesland was soon too small for the company’s activities and it started new production in Utrecht in 1919. Douwe Egberts (as the firm was then called) internationalised in 1927 opening production and distribution activities in Germany. As of 1948 Douwe Egberts expanded into Belgium, Denmark, France and Spain. It has grown by acquiring companies at home and abroad in the 1960s and 1970s.

In 1978 Douwe Egberts merged with US-based Consolidated Foods Corporation that changed its name into Sara Lee Corporation in 1985. Douwe Egberts brought its old culture and colonial products: coffee, tea and tobacco to the new company, Sara Lee/DE. At the time of the merger the Netherlands, Belgium and Denmark accounted for 80-85 percent of the company's turnover.[1] At present more than 65 percent is generated outside the Netherlands. More than fifteen years of acquisitions of Sara Lee/DE have brought together a wide portfolio of brands that are marketed all over the world. It employs about 25 000 people of which 12 percent in the Netherlands.

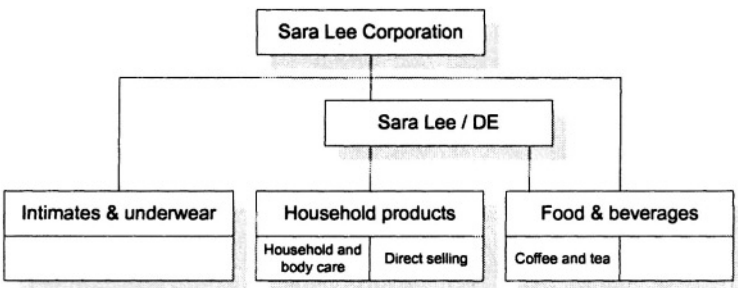
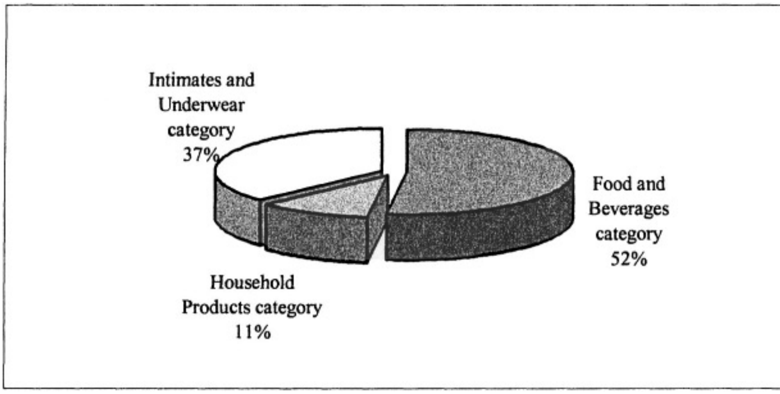


Figure 10-1. Operational structure of Sara Lee Corporation[2]

2. PRODUCT AND GEOGRAPHIC MIX

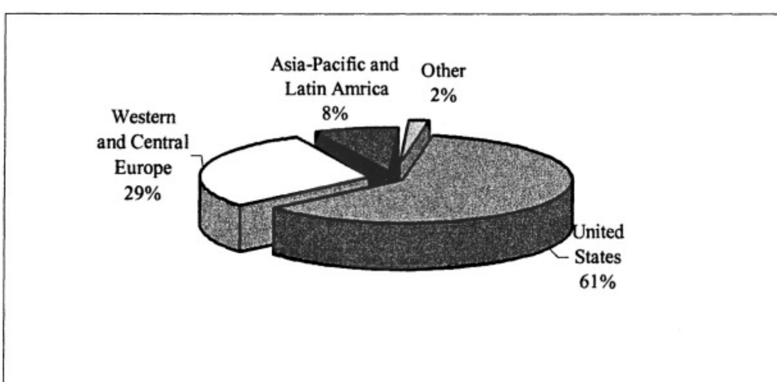
Food and beverages, with coffee and tea as main product groups, account for more than the half of the company's product portfolio (see Figure 10-2). The Douwe Egberts brand, which is more than 200 years old, has helped to make Sara Lee/DE the second largest roasted coffee company in Europe, achieving sales of approximately US$ 17 billion. The company holds the number one marketing position in the Netherlands, Belgium and Hungary. Despite frequent fluctuations in the green coffee price, Sara Lee/DE manages to increase sales and the operating income. The international tea brand Pickwick has increased its position on European market, in which Sara Lee/DE holds first place in the Netherlands and Hungary, and a leading position in Belgium, Denmark, Germany and the Czech Republic. Among the household and body care brands, Kiwi is the world's largest brand in the area of shoe care products and it is available in more than 200 countries. Sara Lee/DE has secured a leading position in many body care products.



Source: Sara Lee Annual Report 2002

Figure 10-2. **Sales by product category, 2002**

The United States are the main market of Sara Lee (see Figure 10-3), while Europe is the main market of Sara Lee/DE. Close to 70 percent of Sara Lee/DE's sales are in the European market, with the Netherlands still claiming a large share of about 20 percent.[3] The international expansion of the company into developed countries is primarily based on the acquisition of new brands that add to the diversification of the product portfolio. In Central and Eastern Europe, the Far East and Latin America, Sara Lee/DE acquired local companies that could deliver high market shares and ensure profitable growth.



Source: Sara Lee Annual Report 2002

Figure 10-3. **Sales by geographical region, 2002**

Sara Lee has a leading position on the European coffee-market with brands such as Douwe Egberts (the Netherlands, Belgium and the UK), Marcilla (Spain), Maison du Café (France), Merrild (Denmark) and Bravo (Greece).[4]

3. CORPORATE STRATEGY

SaraLee/DE's mission is to serve their customers' and consumers' needs through the blending, manufacturing, marketing and selling of consistently high quality, fast moving, branded consumer products. Sara Lee/DE balances its business over various product groups and geographical areas, which are competitively strong and financially sound. Company's primary purpose is to create long-term shareholder value.

Sara Lee/DE's core responsibility within this mission is with the Coffee and Tea division (as part of Food and Beverage), the Household and Body Care division and Direct Selling activities (as part of Household products).

Sara Lee/DE's main overall strategy emphasises entrepreneurial management, consumer and customer satisfaction, global expansion and improved returns. The company operates within a decentralised management structure consisting of profit centres with a high degree of accountability, responsibility and authority. The company aggressively builds its brands in existing markets and extends the geographic reach of its business. Increased returns are the basis for the profitable growth of Sara Lee/DE.

The company operates on the basis of three- to five-year strategic plans concerning turnover, profits and market share targets, following the planning practice at Sara Lee Corporation.[5] A common "code of conduct" that more than 400 managers are asked to sign each year accompanies the decentralised management system. The code of conduct together with the flow of directives from Chicago headquarters define growth targets of 8 percent, a 60:40 ratio of shareholder's equity to loan capital and a leading position in the relevant market.[6]

Sara Lea/DE has six growth strategies[7]:

1. *Globalisation:* focus on product segments that can be developed on a worldwide basis; consolidating markets around the world; applying dual-branding strategy that provides increased scale and regional differentiation;
2. *Leadership Brands:* build leadership brands worldwide; focus efforts and investments on activities that create the most value for the brands such as strong marketing driven product development; conduct ongoing research to keep close to the market;

3. *Multiple channels:* traditional supermarkets; foodservice distributors; mass merchandisers; traditional department/ specialty stores; company-owned retail/outlet stores; direct selling and catalogue operations; Internet;
4. *Product leadership:* product innovation is essential to generate growth in relatively mature categories; managing the product development process efficiently, balancing costs with opportunities and focus resources effectively is crucial;
5. *Breakthrough economics:* create cost effective business models which yield significant competitive advantages and high returns; driven by a number of factors such as global presence, superior competitive scale, improved asset utilisation, proprietary production processes, sourcing networks and knowledge management;
6. *Entrepreneurship:* The local management is given a large measure of responsibility for the marketing of their brands, for following trends and shifts in the markets they operate on. Less directly consumer or market-centered processes, such as production and staff support, are being centralised in order to achieve higher efficiency and cost reduction.

4. SARA LEE/DE'S APPROACH TO GLOBAL EXPANSION

Sara Lee/DE believes that it can only serve its customers if it is close to them. To enter and serve local markets is the primary objective of the company when investing abroad. Particularly with regard to coffee one has to be in the market, to know the client. The economy of scale effect in coffee and tea is very low and the cost advantages do not contribute greatly. Ninety per cent of the costs arise from the raw materials alone. The production of Pickwick tea in Hungary, for instance, benefits, if only to a small extent, from the lower wages there.

Sara Lee/DE prefers to serve local markets through its own production units. Therefore, acquisition and greenfield operations are very important to the company.

Expansion into new markets is a "must" if it is profitable. Not the lack of money can be a problem issue at Sara Lee/DE, but it is the lack of capable management looking for new opportunities. At the same time one should weigh the opportunities against the financial status of the company. For instance, Sara Lee/ DE acquired Akzo Personal Products in 1987 for € 0.5

billion, a major investment at the time. Of course, one could not make such another large investment so soon after that.

Serving local markets as close as possible highlights another important issue: the cross-border transfer of brands. In this respect Sara Lee/DE strongly dislikes the word "commodity products". Every product, in any stage of its life, needs to offer an added value, to both the customer and the company. "We talk about brand names: these are well known products; the company knows everything, for instance how to market them and the consumer behaviour is ready to accept them. For example, coffee in France is different from that in the Netherlands or Hungary. The variety you produce is important and to know which brand name to offer (which blend), which market approach to select", says former director C. D. van der Vijver.[8] In order to introduce international brands into new markets one should take into account the traditional behaviour of customers. In Central and Eastern Europe the traditional behaviour is Turkish versus filter coffee for instance. The special way Russians make and drink coffee makes quick acceptance of the internationally recognised Douwe Egberts filter coffee brand quite difficult. In the same line of argument, instant coffee, for example, may have a greater chance of success in Russia than filter coffee. If one compares consumer behaviour in Hungary and in the Czech Republic, it is well known that Hungarians have greater affinity to a cup of strong, high quality coffee. In order to learn more about the consumers, Sara Lee/DE conducts market research, test sessions, and then it optimises the assortment it offers to a country. The international brands are often mixed up with local brands with high market share that are offered to the customers in new packaging and often in a new variety. The so-called "dual branding" has been and still is one of the key elements of corporate expansion to new market. Acquiring a powerful for the domestic market local brand means for Sara Lee/DE immediate market share, immediate consumer trust and immediate returns. For instance, the acquisition of the *Pilão* and *Caboclo* brands in addition to *Café do Ponto* and *Seleto* in Latin America ensured the company with a leadership position in this continent's key market. In Spain, the local *Marcilla* brand is the preferred product of Sara Lee/DE. Similar is the situation in France with *Maison du Café* brand, in Denmark with *Merrild* and in the USA with *Superior* or *Chock full o'Nuts.*

Sara Lee's strategy is to make a quick entry into a market by acquiring a product leader with well-known brand. The company then builds up market share by expanding into a line of related products, creating what it calls a "mega brand".[9] In Brazil for instance Sara Lee/DE took over Café do Ponto S.A. in 1998, one of the largest producer of coffee in the country with a retail chain of 168 coffee stores. "The take-over of Café do Ponto means a first entry for our company to the very important market of Latin America",

according to Frank L. Meysman, Chairman of the Board of Management.[10] Some local brands grow into global brands for the company. In early 1990s for instance Sara Lee bought a large and prominent brand in France called Dim; hosiery it its principal product. Sara Lee has been building that up into a pan-European brand. Sara Lee selects the brands that it wishes to become global brands. In bakery products the company has the ambition to be a pan-European brand. In coffee, the company is very comfortable with keeping the local brands.[11] Although without country barriers, Sara Lee sees Europe as a fragmented market, much more regionalised than the US. This needs a careful decision on which brands to make pan-European and which regional.[12]

The rapid expansion of Sara Lee into Europe in the 1990s was based on two major experiences that the company brought from the US: knowledge how to manage a large manufacturing operation and how to carry out marketing of packaged goods.[13]

Sara Lee's principal edge is that it is creating and buying the trust of companies from building brands.

Sara Lee/DE does not prefer export as a form of expansion. Exporting usually offers existing formulae that might not be acceptable to the local market. Nevertheless, in places where direct investment opportunities do not exist, or at least for the time being, direct selling and trade offices come into use.

5. DECISION-MAKING TOWARDS CENTRAL AND EASTERN EUROPE

The decision-making process at Sara Lee/DE with regard to world-wide expansion is very much influenced by the common spirit of decision making at Sara Lee Corporation which stimulates entrepreneurial management. It is also influenced by the organisational structure of the Corporation that is highly decentralised into product groups and decentralised within the product groups. When the meat market in US had difficulties assuring the growth of the company, despite her strong market share, it was a US-based decision to move to Europe. Now, there is one co-ordinator within the structure, a European manager, who reports directly to Chicago. The grocery and coffee division in Utrecht can take any kind of cross-border decisions. The decentralisation of decisions goes further still. The national companies can also take decisions for internationalisation. For example, there is a coffee company in Denmark, which has developed strong export links with the Baltic states. In some cases national companies compete amongst each other. This happened, for example, in the field of Pickwick tea exports.

The expansion towards Central and Eastern Europe did not differ from any other decision. The only difference was that it took considerably more preparatory time because the region was not well known to the company. Usually it is the Strategy and Business Development Department that comes up with expansion and acquisition suggestions. Desk studies, visits and talks with embassy representatives and travels to the region are all part of the preparation stage regarding expansion and acquisition suggestions. Forms of expansion such as takeovers and greenfield operations or others are investigated. The expansion plans are forwarded to the Board of Directors that consults with the product groups where the market signals usually come to. A "yes" decision is followed by further preparatory work which aims to decide on the form of expansion, select a partner when necessary, build up mutual understanding and select the type of product that will have the best future in the region.

Central and Eastern Europe was not considered by Sara Lee/DE as a whole. Each country was and still is, approached individually unless of course the spending level and the general business conditions are insufficient. The spending level is important especially for coffee because this product consists of 90 percent coffee as a raw material. Coffee has a world price and the price of the coffee for the consumers cannot differ much between countries. Tea is cheaper and can be more easily shifted to markets with a low purchasing power. On these two basic criteria, for instance, Romania and Bulgaria were last to be approached.

Sara Lee/DE considered the following business conditions in CEE to be very important for investment decisions:

- Economic climate (external debt, inflation, stability of currency, privatisation);
- Market opportunities and market size;
- Political climate.

Investment incentives, a developed legal system, a developed infrastructure, the availability of skilled and transparent labour and financial and product markets are not considered key issues when investing in CEE. If, for instance, the country is lacking a sufficiently developed distribution system, opportunities for the company to build its own distribution channels are created. Obviously, the main legal safeguards for doing business should be present. The most important issue concerning the labour market is the way of thinking and the pace with which changes are introduced.

6. FORMS OF INVESTMENT

The decision regarding the form of investment is very much defined by the attitude of the company that its involvement in any cross-border investment should have a long-term perspective. Any long-term involvement takes a lot of energy and effort that very often also takes a considerable amount of time. For example, a coffee company taken over in Denmark required nine years of negotiations before the take-over could be completed.

Wherever Sara Lee/DE sees a strategic opportunity for investments, it prefers greenfield investments and majority participation. These are the most important forms of investment for the company, and the majority participation should eventually lead to full ownership. In Hungary and the Czech Republic, for instance, the company took over local producers (100% ownership) through privatisation in 1991 and 1992 respectively. If there are no such opportunities, the company rather develops export activities. It has established sales offices in Russia and Poland and agents in Bulgaria, Romania, and the Ukraine by mid-1990s.

In Poland Sara Lee originally looked at the possibility of acquiring a local enterprise through privatisation, only to find that a ground-up, incremental approach suited its needs better. Sara Lee first approached Feniks, a Lodz-based hosiery manufacturer in 1991. In 1992 Sara Lee dropped the plans for acquiring the company and it started on a smaller scale. Sara Lee leased a building in Lodz, bringing over surplus production equipment from its other manufacturing configurations. The company hired a human resource manager who in turn began to recruit a workforce for the venture. The first advertising and distribution efforts aimed at Warsaw, the capital of Poland. After about a year the venture was able to expand to a nationwide distribution network.[14] In 2002 Sara Lee/DE acquired the Polish coffee manufacturer Prima.[15]

In the case of acquisition and greenfield operations, Sara Lee/DE has some additional decision making criteria, apart from a majority ownership. These are: a return on investment of more than 20 percent, opportunities for high market share and dividends, a convertible currency and political stability. For export the company requires payment in advance in hard currency or short credit.

Since most of the takeovers in CEE were privatisation deals, the company was usually required to commit to follow-up investments in manufacturing operations, to maintain employment for some years and to offer training.

7. INVESTMENT EXPERIENCE

Sara Lee/DE started its expansion into Central and Eastern Europe from Hungary, introducing its best international brands of coffee and tea there. The next was the Czech Republic where Sara Lee/DE started producing coffee and tea. The famous coffee and tea brands spread to the Slovak Republic, Poland, Russia, and the Ukraine through the building up of Sara Lee/DE own marketing channels or through direct sales.

More time was needed to introduce Sara Lee/DE household and personal care products. Bath and shower products were sold first in Hungary, the Czech Republic and Poland. The famous Kiwi shoe care products were introduced in Hungary in 1995. The insecticides business was extended into Hungary, the Czech Republic and Poland.

7.1 Coffee and tea in Hungary

In 1991 Sara Lee/DE acquired the Hungarian company Compack, a manufacturer of coffee, tea, spices, salt, muesli, sweeteners, chemical products, water towers (indeed) and leather. The acquisition was carried out within the privatisation scheme and although Sara Lee/DE's main interest was in Compack's grocery and coffee business, the whole company was bought. The first action of Sara Lee/DE towards improving efficiency was the restructuring of Compack's production, consolidating the company around the core businesses of Sara Lee/DE itself. The next step was the restructuring of three major functions, commerce, finance and accounting, in order to make the switch to Western standards as soon as possible. Sara Lee/DE committed US$ 200 million in investments to the restructuring in order to ensure the high quality of the products. The company also invested in building up a new distribution system that had been totally distorted after the changes in the country. Since management is one of the important factors within the decentralised Sara Lee/DE Corporation, this was also a point of concern in the Hungarian case. Changes in personnel and training of management staff were the first steps taken to help improve the management spirit.

Although in 1991 Sara Lee/DE was one of the first Western companies to step into the Hungarian coffee and tea market, the competition quickly gained speed. The efficiency improvements and the restructuring of Compack occurred simultaneously with the efforts of building up a sustainable market share in the country. In Hungary Sara Lee/DE maintained its number one position in the roasted coffee market. The local brand was kept and it is one of the strongest local of the company. In 1993 it successfully introduced the Douwe Egberts Paloma brand into the country's

relatively large segment.[16] Although retail prices increased in 1995, an action which usually influences the buying habits in less affluent markets such as these of Eastern Europe, Sara Lee/DE improved its market share in Hungary, exceeding a share of 42 percent for the fiscal year of 1995.[17] Special packaging and promotions highlighted the **25th** anniversary of Hungary's Omnia brand. Although the Hungarian coffee market became fiercely competitive, Sara Lee/DE stabilised the volume and market share and recorded an improved result by securing a higher margin on its products between 1995-1996.[18]

The international tea brand Pickwick also developed positively in Hungary. In order to meet growing demands for tea products, Sara Lee/DE undertook major investment projects in 1993 in order to increase the capacity of its Hungarian production unit.

7.2 Coffee and tea in the Czech Republic

In 1992 Sara Lee/DE acquired the Czech producer of coffee and tea Balirny Praha. The investment amounted to some US$ 30 million. The first steps taken in the new company were the restructuring of production and the introduction of modern marketing, finance and accounting systems. The introduction of completely new requirements towards the management, led to severe changes in the personnel, especially at high levels. As a result, 30 out of 300 employees in top positions left due to an inability to change and lack of knowledge of English and computers. English was introduced as the language of communication in the company within six months after the take over. Young people were hired which highlighted the necessity of on the spot training and also training within the overall corporate training programmes of Sara Lee/DE.

Although there were more difficulties than experienced in Hungary, the company gained strong positions in both coffee and tea. Since the two products are very sensitive to changes in purchasing power, the crisis in the Czech Republic in 1994 put pressure on Sara Lee/DE to reinforce its position in a declining market. The company then, with a 27 percent share, held the number two position in the Czech coffee market and the leading position in the tea market.[19]

7.3 Coffee and tea in the rest of CEE

Sara Lee/DE serves the rest of the CEE region mainly from Hungary, the Czech Republic and Poland. To supply the growing Russian and East European markets, capacity was significantly expanded at Pickwick's Budapest production facilities.[20] High quality tea from the West is in great

demand in Russia and as a result the company established a marketing office in 1995 in order to ensure that Pickwick tea would be available in every major Russian city.

8. CONSTRAINTS AND LESSONS LEARNED

There were three major constraints which Sara Lee/DE faced while investing in CEE and for which it suggests some solutions:[21]

1. Everybody underestimates the "people" side of the deal. The management is especially important. To change the mentality takes too long – it may be better to replace some people.
2. The economic climate, especially the red tape, produces constant changes in the rules that prevent you from making a sound plan for the future. In coping with this one can rely on the partners, but again, the mentality of the counter-part manager is difficult to predict.
3. Before, information was "power" in CEE. People keep the information for themselves and this hampers the spirit of co-operation and opens possibilities for playing games. Changing the way of thinking can take a long time unless young people are employed. From some takeover cases, Sara Lee/DE learned that one should change the management faster and should concentrate its efforts on changing the way of thinking within the company.

Particularly in 1991, when Sara Lee/DE first entered CEE (Hungary), most of the necessary services such as due diligence, environmental auditing, market research and advertising to name but a few, were carried out using the help of international firms. Now, almost all of these services can be found locally.

It seems that Sara Lee/DE applied a common approach to the change process in the local companies it acquired. The restructuring of production was necessary in order to make it more efficient and to consolidate around the coffee and tea business. In almost all cases the distribution systems had to be established by the company itself. Even own transport had to be organised. The introduction of marketing as a function within local manufacturers was a "must" as were modern financial and accounting systems.

Sara Lee/DE works primarily with local people in its local markets. In the beginning it is only financial positions that are held by expatriates. Changing the personnel where necessary and training people are among the first actions Sara Lee/DE takes. To build up a strong management team is also one of the first priorities. Sales training was necessary not only at management level but also at lower levels. Regular management meetings

were held, in which representatives from the Sara Lee/DE headquarters were present.

Another important issue with regard to the labour force is the productivity, which is in general lower in CEE than in the Western countries. Although there is an advantage in the low labour costs in comparison with Western Europe, any such advantage gained in the beginning is often neutralised by low productivity. The productivity can be influenced by, among others, introducing bonus systems and other motivation instruments. In the long run, higher production efficiency in terms of organisation and technology can also increase the level of productivity.

9. CONCLUSIONS

Sara Lee/DE has been one of the first Western companies to explore the markets in Central and Eastern Europe. It entered CEE with its coffee and tea products. Following their "dual brand" philosophy, the company has looked at two possibilities:

– Take-over of strong local manufacturers with well established local brands;
– Introducing international (or pan-European) brands by exports.

Privatisation deals allowed for the realisation of the first possibility. Where privatisation deals were not possible, sales offices were established starting from markets with large populations such as Poland, Russia and Ukraine. Greenfield operations were not the preferred option for Sara Lee/DE for Central and Eastern Europe. In many instance Sara Lee/DE uses the production bases in Hungary and the Czech Republic to support its export activities into other countries of the region.

Privatisation deals have the disadvantage that you get a business that is not tailor made in accordance with your requirements. Sara Lee/DE had to restructure most of the acquired local producers mainly by consolidating their core business around coffee and tea. Investments primarily went into the human resources: management reorganisation and training, personnel training and change of attitude.

As in many other international markets, in CEE Sara Lee/DE kept these local brands that offered the company a captive market and an immediate trust of the consumers.

NOTES

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[4] Douwe Egberts betreedt Brazilianse koffiemarkt, Press release, March 16, 1998
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[14] J. Reed, Sara Lee's ground-up approach to Poland, in: Business Eastern Europe, Vol. 22, Issues 32, August 9, 1993, pp. 1-2
[15] Sara Lee/DE Annual Report 2002
[16] Sara Lee/DE Annual reports 1993-1994
[17] Sara Lee Corporation Annual Report 1995
[18] Sara Lee/DE Annual reports 1995-1996
[19] Sara Lee Corporation, Annual report 1995
[20] Ibid
[21] Resulting from interview at Sara Lee/DE

Annex

FDI definitions and statistics

1. DEFINITIONS OF FOREIGN INVESTMENT

Many definitions of FDI are in use.[1] [2] [3] The most commonly used, however, are the definitions of EUROSTAT, IMF, OECD, UN and the World Bank. These definitions are as follows:

EUROSTAT:[4]
The EUROSTAT definition is based on the OECD benchmark definition. The direct investment concept refers to the category of international investment made to acquire (or increase) a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise. The foreign entity or group of associated entities that makes the investment is termed the direct investor. The unincorporated or incorporated enterprise, a branch or subsidiary respectively, in which the direct investment is made, is referred to as a direct investment enterprise. Direct investment involves both the initial transactions between the two entities and all subsequent affiliated enterprises, both unincorporated and incorporated.

IMF:[5]/[6]
The foreign entity or group of associated entities that makes the investments is termed the direct investor. The unincorporated or incorporated enterprise - branch or subsidiary respectively, in which direct investment is made is referred to as a direct investment enterprise.

Foreign direct investment refers to international investments that are made by a resident entity in one economy with the objective to acquire a lasting interest in an enterprise operating in an economy other than that of the investor. The purpose of the investor is to have an effective voice in the management of an enterprise. The significant degree of influence of the direct investor on the management of the direct investment enterprise, in addition to the intention for long-term relationship, defines the "lasting interest".

OECD:[7]

The OECD has a so-called Detailed Benchmark Definition of Foreign Direct Investment. Capital investment by non-residents for the purpose of establishing and maintaining lasting economic relations with a domestic enterprise, with the intention of exercising an effective influence in its management. A word of caution is in place here however: When discussing direct investment flows the OECD does not treat the investment flows for branches in the same way as they treat investment flows for subsidiaries and associated companies.

United Nations:[8]

According to the UN, FDI is: an investment involving a long-term relationship and reflecting a lasting interest in a resident entity in one economy (the direct investor), in an entity residing in an economy other than that of the foreign investor. The direct investor's purpose is to exert a significant degree of influence on the management of the enterprise resident in the other economy. Foreign direct investment involves both the initial transaction between the two entities and all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated. Individuals, as well as business entities may undertake foreign direct investment. As the OECD does, the United Nations (UN) uses different definitions for the associates and subsidiaries and for the branches as well.

World Bank:[9]

Foreign direct investments are all capital transactions that are made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, where the investor's purpose is to have an effective voice in the management of the enterprise. Direct investment includes items such as equity capital, reinvestment of earnings, and other long- and short-term capital.

Observations

While these five definitions differ, they have several common characteristics. In order to be viewed as FDI, the investment must, of course, be made in an economy other than that of the investor. Furthermore, the investment must be made with the intention of long term commitment while the investment should also result in an effective voice of the foreign investor in the management of the enterprise. Some degree of ownership is almost always considered to be associated with this effective voice in the management. The IMF suggests a threshold of ten percent of equity ownership for a foreign investor to qualify as a foreign direct investor.

The OECD and UN definitions of FDI are the most detailed and therefore provide the most information, but they also pose the largest problems in the field of data gathering and analysis (see section 3) The World Bank made an effort to overcome most of these problems by providing a voluntary framework[10] for the treatment of FDI. It covers the admission of FDI, general standards of treatment, transfer of capital and revenues, expropriation and compensation and the settlement of disputes between host countries and investors.

The data in this book are mainly from UNCTAD and therefore UNCTAD's definitions of a number of FDI related indicators are used. Thus, in our definition, FDIs are all capital transactions that are made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, where the investor's purpose is to have an effective voice in the management of an enterprise.

It needs to be mentioned that there is convergence in the definitions used by the different international institutions at present. This makes our job easier.

2. INTERPRETING FDI STATISTICAL DATA

Although the definitions of FDI by the international institutions resemble each other (lasting interest, cross-border, effective voice in management) and although these institutions are combining their efforts to make comparisons of international statistical data possible, difficulties still arise because the individual countries that supply these institutions with data continue to use different approaches to measure the flows of foreign direct investment.

There are three main causes for the lack of comparability between the FDI data of different countries, and the discrepancies between them:

- Firstly, countries differ in their definitions of FDI, since most depart in some way from the conventions recommended by the IMF, the OECD or the World Bank.

- Secondly, countries differ in their methods of data collection; a major problem is the difficulty of identifying the ultimate beneficiary as opposed to the immediate beneficiary of a foreign affiliate (e.g. holding versus working company).
- Thirdly, corporate accounting practices and valuation methods differ between countries.

Institutions like the UN (UNCTAD), the OECD and the EC (EUROSTAT), have made increasing efforts to overcome these problems by setting up a unified data gathering system in each country. The UNCTAD Division on Investment, Technology and Enterprise Development (DITE) has reached satisfactory results so far. Their data, collected through national banks, statistical offices and other national authorities, constitute the main source for reporting on FDI inflows. The OECD provides most of the data on FDI outflows. UNCTAD complements this data from other sources of international organisations. UNCTAD verifies its data by feedback confirmations from the countries. Despite the efforts of UNCTAD and other international organisations, FDI data from CEE countries collected for instance by the foreign investment agencies differ from the international data. In addition, the levels of aggregation and disaggregation are often different. Recently EUROSTAT has started a programme that aims at the unification of data gathering methodologies for FDI statistics amongst others.

The main problems that often arise with FDI data gathering are discussed below. These problems are related to major FDI issues.

Acquisition of real estate

The problem of processing the figures related with real estate is the difficulty of deciding whether the investment should be classified as a portfolio investment or as a foreign direct investment. Several countries exclude private real estate stock from their figures.[11] (See also *Distinction between direct investment and portfolio investment*).

Balance of Payments

For some countries the Balance of Payments is the main source of information on foreign direct investment. Other countries use information directly obtained from companies[12] or get their figures from a special institution (that is not a central bank.)[13] In other cases, only information related to foreign direct investment like capital transactions can be read in the balance of payments capital account (see also *Threshold ownership*). Most countries base the data of the Balance of Payments on the exchange records of the central bank;[14] these are very limited in details. In countries where no company surveys are carried out, this means that no FDI stock data

are available. This, in turn, may lead to the problems described in *Stocks/Flows.*

Classification

FDI statistics can be classified both by country and by industry. The country classification does not, in analogy with *Residents,* necessarily reflect the country of ultimate beneficial ownership of the investment, the country of immediate source of funds, or the country from which amounts borrowed will in fact be repaid. As mentioned under *Residents,* the decisive factor in country classification is the country of operation. The industry classification comes into difficulty when the national industrial classification standards differ. Industry figures should be treated with caution, as the classification does not necessarily reflect the industry in which funds are ultimately employed.

Distinction between direct investment and portfolio investment

The choice of whether an investment should be classified as a portfolio or as a foreign direct investment, can be difficult. For instance, if the stock of investment refers to both the value of financial claims by residents or non-residents, and the value of liabilities of residents to non-residents at a given point in time,[15] problems arise. Financial claims may include shares (corporate equity) and equity in unincorporated enterprises (including branches), that appear to be foreign direct investments and bonds, bills, notes, loans, deposits, financial leases, accounts receivable and payable and prepayments, that appear to be portfolio investments.

In practice it may be difficult to make a clear distinction.[16] To make it easier, foreign direct investment is sometimes defined as the desire of firms to place *their firm-specific assets* in foreign markets.[17]

Flows/Stocks

The difference between stocks (the accumulated investment) and flows (the actual transfers of money) of investment capital is an important one. Too often the stock is viewed upon as the sum of flows. This is however not necessarily true. Reinvested earnings for example, are not a part of the flow and should also be taken into account when determining the stock of investment capital. The stock can be calculated in many different ways. It can be calculated by adding parent-company loans to the capital account of the direct investment enterprise, weighted by the investor's ownership share, whereas loans granted to investors by their direct investment enterprises are deducted from the value of the stock.[18] Stocks can also be calculated on the basis of book value, while flows are at current value.[19] A problem arises when there is a time lag between the publication of flows and stock figures.[20]

Other methods for calculating the stock are: current cost (re-value the portion of the position that represents a claim on plant, equipment and other tangible assets from historical cost to current cost), market value (re-value the equity component of the position to its current stock-market value) and historical value (comes directly from the book-value.) A combination of these methods is often used to determine the stock position as accurately as possible.[21]

Inter-company loans

These loans can be included on an asset/liability basis. However, in some cases loans between an associated company or subsidiary and a mother company are not considered as direct investment unless they run for five years or more.[22] In other cases trade credits between a parent company and subsidiary are not included.[23] Inter-company debt transactions and positions are also excluded in countries if special financial institutions are used,[24] in order to evade taxes.

Lasting interest

One of the main requirements is the definition of ‘lasting interest’. Some countries are more specific and cover only claims intended to remain outstanding for at least a certain period of time.[25]

Reinvested earnings

Reinvested (retained) earnings can be included in the figures as imputed transactions. Reinvested earnings are equal to income before adjustment items weighted by the investor’s ownership share, less dividends paid during the accounting period, weighted by the investor’s ownership share.[26] Problems arise when they are not included.[27] According to UNCTAD,[28] in terms of inflows, reinvested earnings are a considerably larger component of FDI in developing countries than in developed countries. This stems from the attitude of many international companies that ‘one should not withdraw water from a small, growing flower’. In the latter group, inward FDI is overwhelmingly financed from funds brought in from abroad, whereas in developing countries, FDI depends more on profits earned there.

Residents

Residents of a country consist of those economic units that have a closer association with the home country than with any other territory. For enterprises, the country of residence is the country of operation.

Threshold ownership

In some countries,[29] in order for the investment to be viewed upon as FDI, the nominal value of the shares has to exceed certain amount. But even when this is not the case, a minimum share of equity is usually required in order to truly have a voice in the management. While admittedly a percentage seems to be an unequivocal measure, the minimum is usually set at ten percent (this is included in the OECD and IMF definitions).

The United States, for instance, uses two very different approaches to determine whether an investment should be regarded as FDI. On one hand, the Balance of Payments measures at book value the foreign equity inflows into US-based entities of which the foreign investor owns at least ten percent equity share (including inter-company loans and charges, plus reinvested earnings, excluding equity acquired through borrowing either in the US capital markets or from unaffiliated foreigners). On the other hand, US assets deemed under foreign control are measured by the same ten percent over equity interest criterion. The reason for the use of these two approaches lies in the fact that foreigners – through the statutes - typically control far more than they own. The difference between the two approaches can be significant.[30] (See also *Balance of Payments*)

Valuation

Foreign direct investments are principally valued at market price in the international investment statistics. Shares are measured at market value or, where there is no market, at either net asset value or at the director's or auditor's valuation.[31]

The aspects mentioned above might lead to interpretation problems when comparing the statistics concerning FDI, especially in countries that supply well-developed statistical data. In many CEE countries highly detailed data, if any, are not available. In such case the problems described above hardly occur.

Data concerning FDI into CEE come from the appointed statistical offices (the statistical institutes are not always the appointed offices in regard to the gathering of data about FDI), and may contain the following problems:

1. *The data are not complete:*
This problem occurs frequently. In the best-case scenario, FDI inflows and outflows are distinguished in accordance with main investor countries, by industry branches, and by the number of FDI. When the data are broken down by country or by branch, the categories in which they are broken down differ per country, and the categories are not always logical or consistent. This makes it very difficult, if not impossible, to make comparisons in FDI between countries over time. Even when data are

supplied in this optimal breakdown, it is not possible to make quantitative analyses because the data on FDI stock is seen as the accumulated flow of FDI per year. This is of course inaccurate, since it does not allow for the revaluation of existing investments.

2. The data are not accurate:

This is concerned with the problems of data gathering of the institutes. Many institutes lack the resources and thus the ability to properly gather their data.

3. The data are not reliable:

In some cases, the institutes that are appointed to collect the data also serve the government in attracting FDI. In these cases the amounts of estimated FDI often include present and future commitments.

For the reasons mentioned above, we recommend that, when comparing FDI statistics in general, to use only the figures of one international institution that specialises in the subject of FDI. For most Western countries the OECD provides fairly good information regarding FDI. For the rest of the world, including Central and Eastern Europe, UNCTAD is recognised as the source with the most accurate statistical data in the field.

NOTES

[1] In our opinion this definition by Grimwade (see endnote 2) also includes securities that derive their ‘interest’ from dividends or capital gains.

[2] Grimwade, N., *International Trade: New patterns of trade, production, and investment,* London/New York, 1989, p. 144

[3] OECD, Oman and others, *New forms of Investments in developing countries,* OECD, Paris, 1989

[4] European Union Direct Investment 1984-92, EUROSTAT

[5] Balance of Payments manual, 4th edition, IMF 1982, p 137-138

[6] Glossary of Foreign Direct Investment terms and definitions, FDI Glossary – IMF/OECD, 2003

[7] International Direct Investments Yearbook, OECD, 1994

[8] World Investment Report 1993, *Transnational Corporations and Integrated International Production*, United Nations, New York 1993.

[9] World Tables 1994, World Bank 1995

[10] These World Bank Guidelines on the treatment of FDI were provided by the World Bank Group in 1992

[11] e.g. Iceland

[12] e.g. Canada

[13] e.g. Italy, Japan, United States

[14] World Investment Directory, Central and Eastern Europe, Volume II, UN, 1992

[15] e.g. Australia

[16] For example: The purchase of, e.g. property abroad may be recorded as a foreign direct investment but is more akin to portfolio investment. The acquisition of foreign government bonds by an insurance company is regarded as a portfolio investment. If on

the other hand this insurance company has an affiliate in that foreign country that buys these bonds, it is viewed upon as foreign direct investment. Unfortunately, it is impossible to separate this type of portfolio flow from what is more typically meant by direct investment. For this reason some countries, like Greece, make no distinction in their figures between portfolio investment and FDI.

[17] Thomsen, S., *Japanese Direct Investment in the European Community: The product cycle revisited,* World Economic Review, 1993, page 279-300

[18] e.g. Finland

[19] e.g. France

[20] In Germany, for instance, this time lag is 15 months

[21] e.g. the USA

[22] e.g. Greece, Spain

[23] e.g. Portugal

[24] e.g. the Netherlands, the United States

[25] e.g. Canada, one year

[26] e.g. Finland

[27] e.g. Belgium, France, Luxembourg

[28] World Investment Report 1993, *Transnational corporations and integrated international production*, UN 1993, page 19

[29] e.g. Austria

[30] Foreign Direct Investment in the United States, World Financial Markets, JP Morgan, 1989 issue 2

[31] International Direct Investment Statistics Yearbook 1994, OECD, Paris, 1995

Glossary

BIR	Base Interest Rate
CBIM	Cross Border Investment Model
CEAL	Central European Agency Line
CEE	Central and Eastern Europe
CEEC	Central and Eastern European country
CEO	Chief Executive Officer
CEFTA	Central and East European Trade Agreement
CIB	Corporate and Investment Banking, organisational centre of ING Group
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance (also called Comecon)
DDSR	Debt and Debt Service Reduction
DM	The German Mark
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
FEM	Financieel Economisch Magazine
FIA	Foreign Investment Agency

FIE	Foreign Investment Enterprise
GDP	Gross Domestic Product
GMP	Gross Material Product
GVA	Gross Value Added
IFC	International Financial Corporation
IMF	International Monetary Fund
LDC	Less Developed Country
LSNC	Law on the Settlement of Non-performing Credits (see also ZUNK)
MNE	Multinational Enterprise
NAFTA	North American Free Trade Agreement
NSI	National Statistical Institute
OECD	Organisation for Economic Co-operation and Development
SEA	South East Asia
SME	Small and medium sized enterprise
SOE	State owned enterprise
TNC	Transnational Corporation
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNECE	United Nations Economic Commission for Europe
VAT	Value Added Tax
WTO	World Trade Organisation
WIIW	The Vienna Institute for Comparative Economic Studies
WIFO	Austrian Institute of Economic Research
ZUNK	Bulgarian acronym for LSNC

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